

ClientAlert

Financial Markets Developments

Capital Markets | Bank Regulatory | Executive Compensation, Benefits, Employment and Labor
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The House of Representatives' Corporate and Financial Institution Compensation Fairness Act

On July 31, 2009, the House of Representatives (the "House") voted 237 – 185 to approve H.R. 3269, the "Corporate and Financial Institution Compensation Fairness Act of 2009" (the "Bill"). The Bill covers three major areas: (1) a non-binding shareholder vote on executive compensation and "golden parachutes" (commonly referred to as a "say-on-pay" vote); (2) independence standards for compensation committees, compensation consultants and other advisors of compensation committees and (3) disclosures to regulators by certain financial institutions with more than US\$1 billion in assets regarding incentive-based compensation and a prohibition on such compensation that is determined by regulators to be harmful.

The say-on-pay provisions of the Bill are the most likely to be enacted into law in some form or another. Say-on-pay currently applies to companies that received Troubled Asset Relief Program ("TARP") funds and there is a support for say-on-pay among key regulators, including SEC Chairperson Mary Shapiro. Conversely, some of the provisions of the Bill that relate to the independence of compensation committees appear either to be superfluous (for example, proposed compensation committee member independence standards that overlap substantially with existing stock exchange requirements) or require careful consideration (for example, the potential requirement that compensation committees have independent counsel may be burdensome and costly for small and midsize companies). Finally, the potential for the federal government to prohibit certain forms of incentive compensation implemented by financial institutions represents a significant and unnecessary extension of regulatory authority over the private sector in an area traditionally governed by state law.

The Bill will now move to the Senate, where it will likely be referred to the Senate Banking Committee for possible consideration and, one hopes, significant review and amendment.

The say-on-pay requirements of the Bill would not apply to foreign private issuers. Some of the independence standards for compensation committees, consultants and advisors apply on their face to foreign private issuers in much the same way that the audit committee independence requirements of the Sarbanes-Oxley Act of 2002 apply to foreign private issuers. Finally, the incentive compensation disclosure requirements and prohibitions would apply on their face to at least some foreign bank offices in the United States, including federally-licensed branches of foreign banks and FDIC-insured branches of foreign banks. The Bill gives federal regulators authority to determine whether other types of financial institutions should also be covered, but non-US offices of non-US financial institutions should not be covered.



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“Say-On-Pay”

Requirement

The Bill proposes to amend Section 14 of the Securities Exchange Act of 1934 (the “Exchange Act”) to give shareholders a non-binding, advisory vote on executive compensation at the company’s annual meeting (or special meeting in lieu of the annual meeting). The shareholder vote would cover compensation disclosed under the SEC’s compensation disclosure rules for named executive officers, including the narrative compensation discussion and analysis, the numerical compensation tables and the report by the company’s compensation committee.

The Bill also proposes to amend Section 14 of the Exchange Act to give shareholders a non-binding, advisory vote on “golden parachutes.”¹ While golden parachutes that are renegotiated or newly granted at the time of a change of control transaction would be subject to a vote at the shareholder meeting to approve the transaction, a vote would not be required if shareholders had already voted on such arrangement or understanding as part of the annual say-on-pay vote. Disclosure of the arrangement or understanding in proxy statements would be required to be in clear and simple form in accordance with regulations to be adopted by the SEC.²

The Bill states expressly that say-on-pay votes would neither create any additional fiduciary duties on the part a company’s board of directors, nor limit the ability of shareholders to make proposals related to executive compensation. The SEC is required to promulgate rules implementing the shareholder voting requirements of the Bill within six months of its enactment. The Bill would grant the SEC the authority to exempt particular categories of issuers, with particular consideration of the potential impact on smaller companies. The shareholder voting requirements would become effective for any shareholder meetings held more than six months after the effectiveness of the SEC’s rules.

Compensatory arrangements approved by a majority vote of shareholders would be immune from any clawback except (i) in accordance with the terms of the employment contract or (ii) in the case of fraud by the executive to the extent provided by federal or state law. The Bill would authorize the SEC to promulgate rules implementing this provision.

1 A “golden parachute” is any agreement or understanding with a named executive officer regarding compensation that is based on or otherwise relates to an acquisition, merger, consolidation or sale or other disposition of all or substantially all of the assets of the issuer.

2 The proposed vote on “golden parachutes” is similar to that proposed by Senator Charles Schumer in his “Shareholder Bill of Rights.” See our Client Alert from May 2009 titled “Proposed US Shareholder Bill of Rights Act of 2009” available at http://www.whitecase.com/alert_05262009_1/.

Finally, the Bill requires an institutional investment manager to report at least annually how it voted on each say-on-pay and golden parachute vote, unless public reporting of such votes is otherwise required by SEC rule.

Commentary

There continues to be significant debate regarding say-on-pay. Besides companies that received TARP funds, which are required to hold an annual say-on-pay vote, only a small number of companies have implemented say-on-pay of their own volition or as a result of a successful shareholder proposal seeking a say-on-pay vote. In addition, the widespread adoption of majority voting at the majority of large US companies has given teeth to a “no” vote that did not exist under a plurality voting system and calls into question the need for mandatory say-on-pay for all companies. Nevertheless, of all of the provisions in the Bill, the say-on-pay provisions seem most likely to have sufficient momentum to become law. With that in mind, the effective date of the rule should be considered carefully. The current proposal of an effective date six months after the adoption of SEC rules could result in effectiveness during the middle of a proxy season, which is undesirable. In addition, because say-on-pay, properly implemented, involves a process of consultation with key shareholders, companies should be given enough time to engage in such consultation before the vote.

The wording of the say-on-pay provision is similar to the provision contained in Section 111 of the Emergency Economic Stabilization Act of 2008 (as amended by the American Recovery and Reinvestment Act of 2009) (the “EESA”) in that it requires a vote to approve “the compensation of executives as disclosed pursuant to the Commission’s compensation disclosure rules (which disclosure shall include the compensation committee report,³ the compensation discussion and analysis, the compensation tables and any related materials).” As a result, the vote appears to apply to more than just historical compensation paid, but technically includes general compensation policies, which can be forward looking. If adopted by the Senate, we expect that companies will hold a simple “for” or “against” vote based on the exact wording of the Bill even though the meaning of such a vote would be open to interpretation.

Finally, even though NYSE Rule 452 was recently amended to eliminate the ability of brokers to vote uninstructed shares in director elections, no amendment was made to prevent the voting of uninstructed shares in connection with a say-on-pay vote. If say-on-pay becomes law, the NYSE may issue a rule amendment to address this.

3 The “compensation committee report” was not included in the EESA.

Independent Compensation Committee Requirement

The Bill proposes to amend Section 10B of the Exchange Act to require the SEC to promulgate rules within nine months after enactment of the Bill that would mandate national securities exchanges to prohibit the listing of a class of equity securities of a company that does not meet certain standards with respect to its compensation committee:

- **Requirement.** Each listed company must have a compensation committee composed of independent directors. A committee member is independent if he or she does not accept any consulting fee, advisory fee or any other compensation from the issuer other than in his or her capacity as a member of the board of the directors or any board committee. The SEC is granted the power to exempt certain relationships with respect to compensation committee members as it deems appropriate. If a company's board does not have a separate compensation committee, the above requirements would apply to all independent members of the full board.

Commentary. Both the NYSE and NASDAQ already have independence requirements for compensation committee members. The effect of the Bill would be to override the definition of independent director provided by the NYSE and NASDAQ that permits payment of up to US\$120,000 in compensation to an independent director during any 12-month period during the three years preceding the independence determination. Because both exchanges also have a general requirement that no relationship exists that would impair the director's independence, the Bill's blanket prohibition of fees, which mirrors the requirement for audit committee member independence under the Sarbanes-Oxley Act, seems unnecessary. In addition, it should also be noted that the timing of the prohibition on fees is unclear and potentially ineffective. If it is the same as the definition under the Sarbanes-Oxley Act then it is sufficient that no fees are currently paid and any previous periods are covered by the look-back rules of the NYSE and NASDAQ which permit payment of the amount described above. Finally, absent an SEC exemption, the Bill would override the exemption provided by the NYSE and NASDAQ for "controlled companies," which are exempt from the requirement of an independent compensation committee. We believe that the exception for controlled companies should continue to stand.

- **Requirement.** The Bill requires the SEC to establish independence standards for compensation consultants, counsel and advisors.

Commentary. The requirement that there be an independence standard for counsel to a compensation committee raises the question of whether it is contemplated that the SEC would promulgate rules under the Bill prohibiting a law firm from

serving as counsel to the compensation committee if it advised the company or its board on other matters. Some companies already use separate outside counsel for their compensation committees. While this practice is often advisable as a matter of best practice, such a requirement could prove burdensome and costly for small and mid-size companies who typically use one law firm for all board-related matters for reasons of scale and efficiency. This would be an appropriate circumstance for the SEC to use the exemptive authority granted to it by the Bill.

- **Requirement.** The issuer's compensation committee must have the authority to retain independent compensation consultants, counsel and other advisors and have the responsibility for the appointment, compensation and oversight of the work of such independent compensation consultants, counsel and advisors. The issuer must provide appropriate funding, as determined by the compensation committee, for any independent compensation consultant, counsel or other advisor.

Commentary. The compensation committee's proposed responsibility and authority with respect to compensation consultants is similar to the audit committee's responsibility and authority with respect to the company's independent auditors. This seems appropriate with respect to compensation consultants, but, as noted above, the Bill might result in the implication that separate counsel for compensation committees of all companies is required in all cases.

- **Requirement.** Effective one year after the enactment of the Bill, each issuer must disclose in its proxy statement for an annual meeting (or special meeting in lieu of the annual meeting) whether its compensation committee retained and obtained the advice of an independent compensation consultant.

Commentary. This disclosure requirement seems unnecessary. Item 407(e)(iii) of Regulation S-K already requires this disclosure.⁴ Furthermore, in recent guidance, the SEC clarified that, if a compensation consultant plays a material role in the company's compensation-setting practices and decisions, the company should discuss that role in its compensation discussion and analysis.⁵ In addition, the definition of "retained and obtained the advice" of a consultant is open to some interpretation. Smaller companies, in particular, frequently rely on salary studies and benchmark surveys prepared generally by compensation consultants. Does that mean those companies

4 Item 407(e)(iii) of Regulation S-K requires disclosure of "Any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying such consultants, stating whether such consultants are engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person, describing the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement."

5 Regulation S-K SEC Compliance & Disclosure Interpretation Nos. 118.06 and 133.08, available at <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm>.

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have “engaged” the consultant? One assumes those consultants may consider themselves “engaged” if they are identified as the source of the survey in the proxy statement, as would often be required by the SEC.

The Bill would grant the SEC the authority to exempt certain categories of issuers from its requirements and provides that the SEC should adopt appropriate procedures to allow issuers not meeting the new standards to cure defects. The Bill requires the SEC to take into account the potential impact on smaller reporting issuers in promulgating any exemptions from its requirements. The Bill would require the SEC to conduct a study and review the use of independent compensation consultants and the effect of such use, which would be submitted to Congress within two years after the effectiveness of the new requirements.

Incentive-Based Compensation Disclosure Requirements and Prohibitions

Requirement

The Bill would require designated federal regulators (“Federal Regulators”) to jointly promulgate regulations within nine months of its enactment to require designated financial institutions (“Financial Institutions”) to disclose to the appropriate Federal Regulator the structures of incentive-based compensation arrangements. Such disclosure would not require the reporting of compensation of individuals, but must be sufficient for the Federal Regulators to determine whether the compensation structure:

- is aligned with sound risk management;
- is structured to account for the time horizon of risks; and
- meets such other criteria as the regulators may determine to be appropriate to reduce unreasonable incentives for employees to take undue risks that could (i) threaten the safety and soundness of the Financial Institution, or (ii) have serious adverse effects on economic conditions or financial stability.

Also within nine months of enactment, the Federal Regulators must jointly promulgate regulations that prohibit any incentive payment arrangement or feature of such an arrangement that

the Federal Regulators determine, taking into consideration the factors identified above, encourages inappropriate risks by Financial Institutions that could threaten the safety and soundness of Financial Institutions or could have serious adverse effects on economic conditions or financial stability.

The Federal Regulators are (1) the Federal Reserve Board, (2) the Office of the Comptroller of the Currency, (3) the Federal Deposit Insurance Corporation, (4) the Office of Thrift Supervision, (5) the National Credit Union Administration Board, (6) the SEC and (7) the Federal Housing Finance Agency.

The Financial Institutions are (1) banks, thrift institutions whether or not insured by the FDIC and bank and thrift holding companies, (2) SEC-registered broker-dealers, (3) credit unions as defined in the Federal Reserve Act, (4) investment advisors as defined in the Investment Advisers Act of 1940 and (5) Fannie Mae and Freddie Mac. Federal Regulators may also designate any other financial institutions (an undefined term) as a covered Financial Institution. Financial Institutions with less than US\$1 billion of assets are not covered by the Bill.

Failure to comply with the above disclosure requirements and compensation structure prohibitions would constitute a violation of Subtitle A of Title V of the Gramm-Leach Bliley Act and be subject to each regulator’s usual enforcement authority under Section 505 of the Gramm-Leach Bliley Act.

Lastly, the Bill calls for a study by the Government Accountability Office of the correlation between compensation structure and excessive risk-taking in the eight years leading up to the financial crisis.

Commentary

Much comment could be made about the detail of the Bill and its proposed coverage. For example, the inclusion of investment advisors with assets of over US\$1 billion seems inappropriate for several reasons. Overall, however, the notion that the federal government would prohibit particular forms of incentive compensation represents a significant and unnecessary extension of regulatory authority over the private sector in an area traditionally governed by state law. As such, it seems far less likely to pass muster in the Senate than the House.

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