

ClientAlert

Executive Compensation, Benefits and Employment Law

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SEC/Treasury Make Statements on Executive Compensation

Last Wednesday, June 10, 2009, both the Secretary of the US Department of the Treasury and the Chairman of the US Securities and Exchange Commission (the "SEC") issued principles and proposals regarding the structure of executive compensation at all publicly-held US companies. The proposals come as a result of the Obama administration's argument that excessive executive compensation, in the form of pay and incentive bonuses, was a large factor in the downturn of the global financial market in 2008.

Previously, the American Recovery and Reinvestment Act of 2009 (the Act) amended executive pay restrictions and standards that apply to companies that receive monetary assistance from the federal government pursuant to the Troubled Assets Relief Program (TARP). The Act expanded and restated the executive compensation and corporate governance rules that had been established earlier under the Emergency Economic Recovery Act of 2008; however, the Act's amended rules continued to apply only to TARP recipients. See our previous client alert on the TARP restrictions here: http://www.whitecase.com/alert_03182009/. The new proposals set forth by Treasury and the SEC would apply to all publicly-held US companies.

Treasury's "Principles" of Executive Compensation

In his announcement, Secretary of the Treasury Timothy Geithner announced five principles to help guide the future of executive compensation practices, with the goal of "develop[ing] standards that reward innovation and prudent risk-taking without creating misaligned incentives." He outlined the five principles as follows:

- **Compensation plans should properly measure and reward performance**

Geithner indicated the Administration's position that while tying an executive's compensation to his company's performance may reward performance, incentive-based pay can be "undermined" where the incentives practically guarantee the compensation to the executive, or provide for compensation even where the company's performance is substandard when compared to its peer firms. Instead, Geithner suggested, incentive-based compensation should be geared toward "long-term value creation," through the use of internal and external "metrics," or measurements, which could help the compensation committee gauge both the company's performance over time, as well as the individual executive's contributions to that performance.



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- **Compensation should be structured to account for the time horizon of risks**

Geithner echoed the Administration's view that the current financial environment resulted in part from executive compensation practices that rewarded executives for taking excessive risk, without regard to the long-term consequences or sustainability of the short-term gains taking such risks provided. By structuring executive compensation packages around a company's long-term value, he explained, the package will be able to better reflect the "ups and downs" of the economy, so that other tools, such as "clawbacks," will be less necessary. Geithner did note that "different settings and industries" would require flexibility in structuring the executive compensation; however, the end goal would be to "tightly align" an executive's pay with his company's long-term value and soundness.

- **Compensation practices should be aligned with sound risk management**

Geithner advocated the function of compensation committees to conduct, and make publicly available, risk assessments which study the company's executive compensation design. Further, Geithner pointed toward the use of "risk managers" by companies to help determine and manage an executive compensation package that can provide incentive compensation to the company's executives without taking excessive risks.

- **The place of golden parachutes and supplemental retirement packages in executive compensation should be reexamined to determine whether such packages align the interests of executives and shareholders**

Geithner noted that while originally golden parachute arrangements were used only in conjunction with a merger or acquisition of the executive's company, such arrangements are now used for a wide variety of situations (which include, for example, the executive's severance without cause and/or notice). Both golden parachutes and SERPs, he argued, lead to shareholder difficulty in ascertaining the full cost of an executive's dismissal from the company. As a result, Geithner argued that the usefulness of such packages toward incentivizing executive performance, from the shareholders' perspective, should be reexamined.

- **Transparency and accountability should be promoted in the process of setting compensation**

Geithner argued that the disconnect between executive compensation and company performance has existed, in large part, due to the inability of shareholders to obtain detailed and transparent information that adequately explained the executive's compensation packages. In addition, he maintained, the compensation committees responsible for setting and overseeing executive compensation were not sufficiently independent from the company's management to effectively set and monitor such compensation packages.

Geithner explained that in order to further the five principles listed above, the Treasury Department would work with Congress to pass legislation in two areas: one, to give shareholders a non-binding vote on executive compensation packages (often referred to as the "Shareholder Say-On-Pay" idea); and two, to ensure that compensation committees are independent of company management. In conjunction with Geithner's speech, the Treasury Department issued two "fact sheets," intended to provide more information on the upcoming legislation:

- **"Say on Pay"**: This legislation would authorize the SEC to require non-binding say-on-pay votes for all public companies. Under the legislation, shareholders would have the right to: (i) cast a non-binding vote to approve or disapprove the company's executive pay packages; (ii) vote on the annual compensation of the company's top five executives, as disclosed in the company's proxy statement, including each executive's salary, bonus, incentive compensation, and other forms of compensation and (iii) cast a non-binding vote to approve or disapprove any golden parachute compensation.
- **Independent Compensation Committees**: Designed to give compensation committees greater independence from company management, this legislation would direct the SEC to: (i) create and issue independence standards, similar to those required by Sarbanes-Oxley of audit committee members; (ii) create rules enabling compensation committees to use outside advisers when setting executive pay (e.g., the use of compensation consultants, legal counsel and funding to pay for such advice) and (iii) establish standards to ensure the independence of compensation consultants and any outside counsel engaged thereby.

SEC's Proposals Requiring Greater Proxy Disclosure

Concurrently with the Treasury proposals, SEC Chairman Mary Schapiro announced that the SEC is currently considering new proxy disclosure rules that would provide further explanation to shareholders regarding the rationale for executive compensation decisions. To that end, the rules would require greater disclosure of the following:

- The company's, and its board's, risk management strategies;
- The company's overall compensation approach;
- Potential conflicts of interest between compensation consultants hired by the company and the company, its affiliates, and its management; and
- The experience and qualifications of board of director nominees, as well as an explanation for the board's overall leadership structure.

The Treasury and SEC Proposals—What Do They Mean to You?

The rules associated with the SEC's proposals, as well as the Treasury's legislative initiatives on independent compensation committees and shareholder "say on pay" voting rights, would be required of all publicly-held US companies. However, Treasury's five "principles" are designed to reflect a "best practices" approach, and are not binding. As Geithner indicated in his speech, the goal of the Treasury proposals would be to "reward innovation and prudent risk-taking," not to set forth specific executive pay caps or specific rules for calculating compensation. Specifically, with respect to the shareholder "say on pay" element of the Treasury legislation, the Administration believes that, although the shareholder vote would be non-binding, the associated shareholder pressure and potential embarrassment to companies would be enough to make such companies take shareholder views into consideration when designing effective executive compensation plans. Even companies that are not publicly-held can use the Treasury and SEC guidelines in assessing their executive compensation plans to better align those packages with the companies' long-term growth and value creation. As always, White & Case would be glad to help you assess the applicability of the new Treasury and SEC proposals to your company's executive compensation packages.

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