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Recent Executive Compensation and Corporate Governance Developments — A Changing Landscape

July 13, 2009

Since the beginning of the financial crisis in late 2008, Congress and the Department of the Treasury have increased their efforts to regulate executive compensation and corporate governance practices. Similarly, the Obama administration has provided input on its view of necessary reforms and proposed legislation. The Securities and Exchange Commission has also recently approved and proposed a number of changes which will affect executive compensation, governance, disclosure and annual meeting practices. This alert summarizes, in chronological order, many important developments that practitioners, management and boards should all be aware of.

Treasury Announces Executive Compensation Rules Under the Emergency Economic Stabilization Act

In late 2008 and continuing through 2009, the Treasury has been implementing regulations aimed at recipients of funds under the Troubled Asset Relief Program ("TARP"). Among other things, these regulations include:

- Limits on executive compensation and its deductibility;
- Limits on bonuses, retention awards and other incentive compensation;
- Bans on golden parachute payments, limits on their deductibility and excise taxes;
- Bans on tax gross-ups and disclosure and justification for certain perquisites;
- Clawbacks of bonuses based on earnings or other measures that are later proven to be materially inaccurate or where there are deceptive practices;
- Measures designed to address unnecessary and excessive risk;
- Appointment of a Special Master at some firms to analyze executive compensation programs;

- Requirements that executive compensation be subject to a shareholder vote ("Say on Pay"); and
- Requirements for increased disclosure about compensation consultants.

While these regulations are limited to firms receiving governmental assistance, it is apparent that some provisions may form a basis for what the Obama administration deems necessary reforms in all public companies.

Congress Gets Involved — Introduction of the Shareholder Bill of Rights Act of 2009 and Similar Legislation

In May 2009, Senators Schumer (D-NY) and Cantwell (D-WA) introduced the Shareholder Bill of Rights Act of 2009. The bill contains a number of provisions favored by institutional shareholder groups, including:

- Annual Say-on-Pay votes;
- Required approval of golden parachute payments made in connection with M&A transactions;
- Proxy access designed to allow shareholders to use company proxy materials to nominate board members;[1]
- Mandatory separation of the Board Chair and CEO positions and requirement for an independent Board Chair;
- Elimination of staggered boards;
- Mandatory resignation of board members who don't receive a majority of votes cast; and
- Mandatory risk committees of independent directors to establish and evaluate risk practices.

While this bill was the first of its kind during this legislative session, and thus probably has garnered the most attention, there are other similar bills, including the Shareholder Empowerment Act, the Excessive Pay Shareholder Approval Act and the Excessive Pay Capped Deduction Act of 2009. Like the Shareholder Bill of Rights, these bills are also aimed at reforming corporate governance and limiting excessive executive compensation. Whether and when any of these bills will be enacted is unclear, as the Obama administration may have other priorities.

The Obama Administration's Views

In June 2009, Treasury Secretary Timothy Geithner publicly highlighted five principles of the Obama administration developed with the goal of "bringing compensation practices more tightly in line with the interests of shareholders and reinforcing the stability of firms and the financial system":

- 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 carefully 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.

Geithner stated that the administration would propose legislation to give the SEC power to ensure that compensation committees are more independent, requiring standards similar to those in place for audit committees. He also made clear that the administration is not capping pay or setting prescriptions for how pay should be set. Instead, as Geithner stated, "we will continue to work to develop standards that reward innovation and prudent risk taking, without creating misaligned incentives."

These five principles were expanded later in June when the Obama Administration issued its Financial Regulation White Paper, describing the broad goals of ongoing financial regulation, including executive compensation. The White Paper also indicated that the administration would support non-binding Say-on-Pay requirements and the creation of SEC standards to ensure the independence of compensation consultants.

The SEC Speaks

Also in June 2009, SEC Chair Mary Schapiro announced that the SEC would consider a number of corporate disclosure improvements addressing, among other things:

- Directors and nominees, including further disclosure about their experience and qualifications;
- Why a board has chosen a particular leadership structure (i.e., combined chair/CEO or lead director);
- How a company and its board manage risk (and its impact on compensation policies at all levels);

- A company's overall compensation approach (including beyond the executive level); and
- Compensation consultant conflicts of interest, including disclosure of relationships between a consultant and a company and/or its affiliates.

Just a few weeks later the SEC held an open meeting to propose new rules addressing these and other topics. The SEC's proposing release includes additional or enhanced disclosure obligations for each of the items listed above, some or all of which seem likely to be required in next year's proxy statement for calendar year-end companies.

The SEC also proposed to undo its December 2006 rules on valuing and reporting annual stock and option awards to executive officers and directors, which required that they be valued in accordance with FAS 123(R)'s expensing rules. The proposal would revert to the original August 2006 formulation and require that the full grant date fair value of equity awards be reported in the Summary Compensation and Director Compensation tables.

To ensure that shareholders receive more timely information about meeting results, the proposal would also require companies to report voting results immediately on a Form 8-K, rather than in the quarterly report for the period during which the meeting was held, as is currently required.

Finally, and perhaps most notably, the SEC approved an amendment to New York Stock Exchange Rule 452 to eliminate broker discretionary voting for all elections of directors (except for registered investment companies), whether or not contested. This means that if a retail shareholder does not provide explicit instructions to its broker, the broker may not vote the shares in a director election. This new rule will apply to shareholder meetings held on or after January 1, 2010 and could dramatically affect director elections, in particular those at companies with majority voting, as brokers have traditionally tended to vote for management's slate of directors when they had discretionary authority to do so.

While the specifics are currently uncertain, it seems clear that there will be some significant and imminent changes for companies, both in their processes and their disclosures. How far-reaching these changes are remains to be seen.

For additional information concerning this alert, please contact your regular Bingham corporate contact or the following lawyers:

Laurie A. Cerveny
laurie.cerveny@bingham.com
617.951.8527

Michael P. O'Brien
michael.obrien@bingham.com
617.951.8302

David K. Robbins
david.robbins@bingham.com
213.680.6560

ENDNOTES

[1] See Bingham alert entitled "Proxy Access": SEC Proposes Rules to Facilitate Director Nominations by Shareholders, dated June 2009, for a discussion of the SEC's recent Proxy Access proposal.