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Treasury's Take on Executive Compensation: It's a Matter of Principles

On June 10, 2009, the U.S. Department of the Treasury ("Treasury") issued:

- A Statement by Treasury Secretary Tim Geithner on Compensation (the "Principles"), which sets forth five broad-based principles on compensation policies and practices applicable not only to financial institutions, but to companies generally,

- A Fact Sheet entitled "Providing Compensation Committees With New Independence" (the "Compensation Committee Fact Sheet"), and

- A Fact Sheet entitled "Ensuring Investors Have a 'Say on Pay'" (the "Say on Pay Fact Sheet").

These documents were published following Secretary Geithner's meeting with Mary Schapiro, Chairman of the Securities and Exchange Commission ("SEC"),[1] Dan Tarullo, Governor of the Federal Reserve, and "top experts" to discuss ways to "better align compensation practices – particularly in the financial sector – with sound risk management

[1] On July 1, 2009, the SEC proposed amendments to disclosure rules for U.S. companies regarding matters of compensation and corporate governance, including to require disclosure about the relationship of a company's overall compensation policies to risk and more information about the company's use of compensation consultants (the "SEC Proposed Amendments"). *See* Mary L. Schapiro, Chairman, SEC, "Speech by SEC Chairman: Statement at SEC Open Meeting" (July 1, 2009); Sean Harrison, Special Counsel, SEC, "Speech by SEC Staff: Division Statement before the Commission Open Meeting: Proxy Disclosure and Solicitation Enhancements" (July 1, 2009). The SEC Proposed Amendments would also require more disclosure about the qualifications and experience of directors and director nominees and the company's leadership structure. In addition, the SEC Proposed Amendments would: require that grant date fair value of equity awards be included in the Summary Compensation Table, require accelerated reporting of the voting results of stockholder meetings and implement clarifications of certain proxy solicitation rules. At the same open meeting, the SEC proposed rules regarding the say on pay vote required under § 111(e) of the Emergency Economic Stabilization Act of 2008, 12 U.S.C. 5221 ("EESA"), as amended by the American Recovery and Reinvestment Act of 2009 ("ARRA"), for companies that have received financial assistance under the Troubled Assets Relief Program established by EESA ("TARP"). The SEC's proposed rule on say on pay voting for TARP recipients (the "TARP Say on Pay Proposed Rule") is available on the SEC's website. The text of the remainder of the SEC Proposed Amendments is not yet publicly available.

and long-term growth." The Principles can be read as an outline of goals for legislative and regulatory reforms to come.

Overall, these materials suggest that the government will take a measured approach in their efforts to reform compensation practices.[2] Recognizing the dangers in creating substantive, one-size-fits-all compensation requirements and prohibitions, Secretary Geithner states in the Principles that he "want[s] to be clear on what [Treasury is] not doing. We are not capping pay. We are not setting forth precise prescriptions for how companies should set compensation, which can often be counterproductive. Instead, we will continue to work to develop standards that reward innovation and prudent risk-taking, without creating misaligned incentives."

In our view, the Principles rightly signal that any laws to be enacted or rules to be issued should leave room for companies to make individualized decisions about how best to structure and implement their compensation programs. In the words of Richard Thaler and Cass Sunstein in the introduction to their book *Nudge*, "better governance requires less in the way of government coercion and constraint, and more in the way of freedom to choose. If incentives and nudges replace requirements and bans, government will be both smaller and more modest."[3] However, the Principles do leave room for misguided legislation and implementation.

The Principles and Fact Sheets announce Treasury's support for, and broadly outline recommendations for the parameters of, forthcoming legislation regarding say on pay voting and compensation committee independence. With respect to the design of incentive compensation, we believe that the Principles would best be read to emphasize the following three important (if unremarkable) points:

- Compensation for each employee should be tailored to incentivize the employee to achieve the results the company desires relative to the employee's position.
- Performance criteria for incentive compensation should be multiple and varied and should provide incentives to achieve an appropriate balance among the company's objectives.
- Stock and stock-based awards should be used only where appropriate and should not be viewed as a panacea for addressing the problem of excessive risk taking.

[2] President Obama's proposal for financial regulatory reform announced on June 17, 2009 reiterates the administration's focus on the principles described herein. DEPT. OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (June 17, 2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.
[3] RICHARD H. THALER AND CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 14 (2009).

The Principles are by design broad and generic, and therefore resemble tea leaves to be read for hints of the actual legislation and regulation to come. In this memorandum, consistent with what we understand to be the purpose of the Principles, we identify some of the key practical implications of the Principles for purposes of compensation design and the potential reforms that the Principles appear to endorse.

Principle One: **"[C]ompensation plans should properly measure and reward performance."**

This principle states that "[c]ompensation should be tied to performance in order to link the incentives of executives *and other employees* with long-term value creation" [emphasis added] and that "[t]o align with long-term value creation, performance based-pay should be conditioned on a wide range of internal and external metrics, not just stock price."[4]

The reference to "other employees" echoes the position other regulators, such as the SEC, have taken in looking beyond just the top executives for purposes of both disclosure requirements and risk review. This reflects a concern that even lower-level employees, such as those incentivized to book mortgages without regard to the mortgagors' ability to pay, can in the aggregate have a detrimental effect on the company as a whole. A similar concern is reflected in the SEC Proposed Amendments that would require U.S. public companies, in the Compensation Disclosure and Analysis section of their proxy statement or Annual Report on Form 10-K ("CD&A"), to "discuss and analyze [their] broader compensation practices for employees generally, including non-executive officers, if the risks arising from those compensation policies or practices may have a material effect on the company."[5]

From a compensation design perspective, using multiple performance metrics that encourage employees to strike an appropriate balance among applicable objectives in and of itself discourages excessive risk taking.

- For example, if a mortgage originator has a portion of his or her compensation tied to both the volume of mortgages he or she books and the mortgagors' actual

[4] Ironically, companies that have received (and have not repaid) financial assistance under TARP are limited to granting incentive compensation only in the form of restricted stock, restricted stock units or similar phantom stock arrangements meeting the requirements of EESA. As a result, any metrics other than stock price would have to be built into either the size of the award or applicable vesting conditions. For additional information about executive compensation restrictions under ARRA, please see our February 16, 2009 memorandum entitled "Overview of the Executive Compensation Provisions of the American Recovery and Reinvestment Act of 2009," *available at* http://www.cgsh.com/overview_of_the_executive_compensation_provisions_of_the_american_recovery_and_reinvestment_act_of_2009/, and our June 17, 2009 memorandum entitled "New Regulations Implement EESA and ARRA Compensation Restrictions," *available at* http://www.cgsh.com/new_regulations_implement_eesa_and_arra_compensation_restrictions/.

[5] Sean Harrison, Special Counsel, SEC, "Speech by SEC Staff: Division Statement before the Commission Open Meeting: Proxy Disclosure and Solicitation Enhancements" (July 1, 2009).

performance under the loans, the compensation will not encourage the mortgage originator to book loans without regard to risk in a single-minded effort to maximize volume.

Moreover, especially for non-executive employees, stock price is not necessarily the best incentivizing carrot or risk management stick.

- For example, a salesperson may feel that he or she cannot influence the actions of the company as a whole (and as a result, the stock price), but can impact the company's revenues, in which case revenues may be a more appropriate metric than stock price on which to base his or her compensation. With regard to risk management, the risks a salesperson may be incentivized to take are not necessarily countered by risk management policies aimed at the company as a whole.

We believe that the government's ever-heightening focus on performance metrics may bring other pressures to bear on public company practices. As part of the rationale behind the first principle, Treasury explains that "[i]ncentive-based pay can be undermined by compensation practices that set the performance bar too low, or that rely on benchmarks that trigger bonuses even when a firm's performance is subpar relative to its peers." This emphasis on performance relative to peers will likely spur further questions regarding the identification of the appropriate peer group against which performance should be measured, and how that group should compare with any peer group identified for purposes of benchmarking compensation levels generally. Any U.S. public company that engages in benchmarking must identify the peer group used in its CD&A.[6]

Additionally, Treasury's reference to "set[ting] the performance bar too low" likely will reinforce SEC initiatives to require public companies to disclose quantitative performance targets in their CD&A.[7] Indeed, a bill recently introduced in Congress by Rep. Gary Peters (D-Mich.) would direct the SEC to develop rules requiring additional disclosure about

[6] *See* Int'l Bancshares Corp., SEC Letter re: Review of Proxy Statement for Executive Compensation and Other Related Disclosure, at 3 (Nov. 6, 2007) (excerpt available at http://www.compensationstandards.com/Member/Areas/SECcomments.htm) (acknowledging that an issuer may use different comparator groups for purposes of benchmarking different elements of compensation as long as the issuer identifies the companies that comprise each group); John W. White, Dir., Div. of Corp. Fin., SEC, "Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009" (Oct. 21, 2008) (encouraging disclosure about selection of peer group). S*ee also* MOODY'S INVESTOR SERVS., EXPANDED DISCLOSURE ON U.S. EXECUTIVE COMPENSATION OFFERS NEW CLUES FOR CREDITORS (2008) (suggesting that the use of multiple peer groups in certain situations may be a "red flag" for investors).

[7] For more information about the issue of target disclosure, please see our September 14, 2007 memorandum entitled "The Materiality of Performance Targets," *available at* http://www.cgsh.com/the_materiality_of_performance_targets_in_proxy_disclosure/.

performance targets, including disclosure "in situations when it is claimed that disclosure would result in competitive harm to the issuer . . . ."[8]

Principle Two: **"[C]ompensation should be structured to account for the time horizon of risks."**

The second principle states that "[c]ompanies should seek to pay top executives in ways that are tightly aligned with the long-term value and soundness of the firm" and suggests that stock holding periods for executives "may be the most effective means of doing this . . . ." The Principles stop short of endorsing mandatory holding periods, recognizing that "directors and experts should have the flexibility to determine how best to align incentives in different settings and industries."

Stock retention guidelines – i.e., policies requiring executives to own a certain amount of company stock (which amount typically is based on their level of pay) for a certain period of time (the duration of which is usually long-term, sometimes for as long as the executive remains employed with the company) – have become increasingly common in recent years.[9] In the financial services industry, a three-year (or longer) ownership requirement historically has been typical,[10] and some companies have required not only executives, but virtually all employees, to hold a substantial portion of their bonuses in company stock for this period.

The second principle also suggests that basing compensation on long-term rather than short-term performance is an efficient way for companies to ensure that the payment of awards accounts for the risks that attend achievement of the relevant performance goals. "Compensation conditioned on longer-term performance will automatically lose value if positive results one year are followed by poor performance in another," which, the principle states, will "obviat[e] the need for explicit clawbacks." Presumably this principle could be implemented through:

[8] Shareholder Empowerment Act of 2009, H.R. 2861., 111th Cong. (2009) (the "Shareholder Empowerment Act").

[9] *Equilar Executive Stock Ownership Requirements*, Equilar Executive Compensation Trends, Oct. 2008, at 5, *available at* http://www.equilar.com/newsletter/2008_10/2008_10_ect_main.html ("The prevalence of Fortune 250 companies with publicly disclosed executive stock ownership policies increased from 80.9 percent in 2006 to 82.6 percent in 2007.").

[10] *See, e.g.*, Bear Stearns Companies Inc., Proxy Statement (Schedule 14A), at 9 (Apr. 18, 2007), *available at* http://www.bearstearns.com/sitewide/investor_relations/sec_filings/proxy/index.htm; Lehman Brothers Holdings Inc., Proxy Statement (Schedule 14A), at 14 (Mar. 15, 2008), *available at* http://www.sec.gov/Archives/edgar/data/806085/000104746908002261/a2183244zdef14a.htm. Both companies indicate in their proxy statements cited above that they pay the majority of their named executive officers' annual incentives in the form of equity awards, which vest over a two- or three-year period and which (with the exception of certain stock options granted by Bear Stearns that cliff vest at the end of a three-year period) are subject to five-year holding periods.

- Multi-year performance-based vesting provisions, pursuant to which some portion of an award would not vest if performance declines, or if the participant engages in detrimental conduct, during the vesting period,

- "Malus" adjustments,[11] pursuant to which some vested portion of an award would be reduced in the event of poor performance or detrimental conduct prior to pay-out, and/or

- Notional adjustments to deferred compensation accounts, pursuant to which the amount of compensation the employee will receive at pay-out would be formulaically tied to various metrics reflecting company performance during the deferral period or the results of the business unit in which the employee works.[12]

Indeed, for ease of administration (and to avoid any legal challenges to clawbacks), companies may find it preferable to use some form of vesting and/or pre-payout adjustment mechanisms instead of relying on clawbacks to recapture compensation after it has been paid.

While the Principles support the idea that company stock price is a key performance measure for the alignment of compensation with long-term performance and risk, it is important to note that the senior executives of each of Lehman Brothers and Bear Stearns received a significant portion of their compensation in (and had a significant portion of their wealth concentrated in) company stock. While we agree that stock is a valuable element of incentive compensation, we believe that in order to enhance the efficacy of stock-based incentives in meeting the desired goals, companies should also consider the use of other performance metrics in determining size, vesting and claw-back of stock awards.

The second principle also focuses on employees beyond the company's most senior management. It directs companies to "carefully consider how incentives that match the time horizon of risks can extend beyond top executives to those involved at different levels in designing, selling and packaging both simple and complex financial instruments." This could be read to endorse an idea that has recently emerged in the public discourse over executive compensation reforms that, for employees selling financial products, some portion

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[11] For example, UBS AG has instituted a "malus system" whereby at least two-thirds of annual variable cash compensation "will be held in an escrow account and kept at risk for future performance." UBS AG, UBS's New Compensation Model (Nov. 17, 2008), *available at* http://www.ubs.com/1/e/investors/compensationreport.html.

[12] In December 2008, Credit Suisse announced that it would link a significant portion of deferred equity bonuses for senior investment bankers to risky, illiquid assets they had sold to investors, establishing what Reuters called "an innovative new bonus system that may set an example for others in the industry." Emma Thomasson, *Credit Suisse bonus plan takes on risk of assets*, Reuters, *available at* http://www.reuters.com/article/ousiv/idUSTRE4BH5MT20081218.

of their compensation should be subject to terms that mirror the upside potential – and downside exposure – of the products they sell.[13]

However, we would caution companies against lumping together employees involved in "designing, selling and packaging" financial products without taking into account the different goals of each of these jobs. While it might be appropriate to tie the designer's compensation to the risks inherent in the instrument, a different metric may be more appropriate for packagers and salespersons.

We believe the most important point underlying the Principles is the completely commonsense proposition that incentive compensation should be matched to job function. This approach to compensation design should serve as a risk management device for the company as a whole, for example, by helping to create balance between a salesperson's efforts to maximize sales today and a designer's efforts to create products that meet the needs of clients in light of their investment strategies, sophistication and other relevant considerations.

***Principle Three*: "[C]ompensation practices should be aligned with sound risk management."**

Pointing to poorly designed compensation programs that have in the past "unintentionally encouraged excessive risk-taking," and poor checks on risk-taking behavior due to a lack of authority for risk managers, this principle proposes two basic fixes.

First, it states that "[c]ompensation committees should conduct and publish risk assessments of pay packages to ensure that they do not encourage imprudent risk-taking." It is unclear whether Treasury meant the reference to publishing to require companies to publicly disclose the committee's assessment. As noted above, the SEC Proposed Amendments would require disclosure about the relationship of overall compensation policies to risk. In an earlier statement, Chairman Schapiro stated that this type of disclosure rule "would lead companies to analyze how compensation impacts risk taking and the implications for long term corporate health of the behavior they are incenting."[14]

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[13] *See, E.g.*, Peter Cohan, *Let Citi Workers Eat Their Own Dog Food*, Daily Finance, May 5, 2009, *available at* http://www.dailyfinance.com/2009/05/05/let-citi-workers-eat-their-own-dog-food/. As an illustration of this idea implemented at the company level, see H.R. 1728 (111th Cong., 2009), passed by the House of Representatives on May 7, 2009, which would "require creditors to retain at least 5 percent of the credit risk on any non-qualified mortgage that is transferred, sold or conveyed.''

[14] Statement on Executive Compensation by Chairman Mary Schapiro (June 10, 2009). Chairman Schapiro's statement and the SEC Proposed Amendments follow earlier indications to this effect from the SEC. In an October 2008 speech, John White, Director of the SEC's Division of Corporate Finance, encouraged non-TARP recipient companies to consider how they should address risk in their proxy disclosure. John W. White, Dir., Div. of Corp. Fin., SEC, "Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009" (Oct. 21, 2008). He stated:

Second, this principle encourages companies to better equip risk management professionals to perform their jobs. It states that "firms should explore how they can provide risk managers with the appropriate tools and authority to improve their effectiveness at managing the complex relationship between incentives and risk-taking." Compensation committees would do well to be introspective in ascertaining what type of culture their respective companies' compensation systems foster. Relevant considerations include whether and how risk management professionals are integrated into strategic planning activities in addition to compliance and control functions, as well as the adequacy and quality of risk management professionals and whether the reporting lines for these professionals are appropriately structured to ensure their independence. While many of these considerations have long been the province of public company audit committees, we believe that many compensation committees have begun to incorporate these considerations into their deliberations as well, including through overlapping membership between the audit and compensation committees.

In considering how best to improve the effectiveness of risk managers through compensation design, companies should consider whether:

- Incentive compensation for risk managers should be linked to the achievement of risk management-related objectives and determined independently of the business units they oversee,

- Risk managers should report to senior risk management staff, and their reporting lines should be independent of the business units they oversee, and

- Risk managers' level of compensation and stature within the company should reflect the critical importance of their function and not their status as a "cost center."

<u>Principle Four</u>: **"[W]e should reexamine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders."**

> [L]et's talk for a moment about non-[TARP] participating companies. This new Congressionally-mandated limitation on having compensation arrangements that could lead a financial institution's senior executive officers to take unnecessary and excessive risks that could threaten the value of the financial institution obviously applies on its face only to participants in the TARP. But, consider the broader implications and ask yourself this question: Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target — with risk, in this case, being viewed in the context of the enterprise as a whole? I'll let you think about what Congress might want.

Id. Indeed, in the 2009 proxy season, non-TARP recipient companies began to discuss risk as it relates to their compensation programs.

With respect to golden parachutes, the fourth principle states that such payments "were originally designed to align executives' interests with those of shareholders when a company is the potential target of an acquisition," but that "[o]ften, they have been expanded beyond that purpose to provide severance packages that do not enhance the long-term value of the firm." This language suggests that Treasury is primarily concerned not with traditional golden parachute payments aimed at (and tailored for the purpose of) providing job and financial security to executives in a change-in-control context, but with severance packages that may be perceived as excessive and/or ill designed for purposes of aligning management with shareholder interests.

With respect to supplemental executive retirement plans ("SERPs"), the fourth principle states that these benefits "can make it more difficult for shareholders to readily ascertain the full amount of pay due a top executive upon leaving the firm." Here, as well as in its final principle, Treasury focuses on the transparency of termination pay packages, suggesting that benefits such as SERPs are not clearly communicated to shareholders as part of the executive's total separation pay. With respect to public companies, Treasury's concern about insufficient disclosure seems misplaced as detailed disclosure of retirement benefits for named executive officers is already required under the SEC's proxy disclosure rules. We believe any additional disclosure on this element of compensation is unlikely to be incrementally informative.

One form of additional disclosure which the Principles may be read to endorse is disclosure of a single number representing the total value of all payments and benefits which each named executive officer would receive in each termination scenario. Treasury states under the final principle (further discussed below) that "existing disclosures typically failed to make clear in a single place the total amount of 'walkaway' pay due a top executive, including severance, pensions, and deferred compensation." While all of the information needed to determine these numbers is currently required to be disclosed under the proxy rules, SERP benefits are disclosed in the "pension benefits" section,[15] termination payments and benefits (including, for example, the incremental value of accelerated payment of SERP benefits, but excluding the amount of such benefits) are disclosed in the "potential payments upon termination or change in control" section[16] and nonqualified deferred compensation in its eponymous section.[17] Companies could be required to add together all such amounts and include the sum total in their proxy disclosure. The value of such disclosure is debatable, especially if the goal of such disclosure is to increase shareholder understanding of compensation packages in light of the overall compensation objectives of the company in the context of its industry and business strategy. In our view, a single "walkaway" number could well end up being the single tree at which shareholders stare as they fail to see the compensation design forest.

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[15] Item 402(h) of Regulation S-K.
[16] Item 402(j) of Regulation S-K.
[17] Item 402(i) of Regulation S-K.

Treasury concludes that "[w]e should reexamine how well these golden parachutes and supplemental retirement packages are aligned with shareholders' interests, whether they truly incentivize performance, and whether they reward top executives even if their shareholders lose value." It is unclear from the Principles who Treasury believes should conduct this reexamination.

- If "we" refers to companies and their compensation committees, Treasury seems to imply that committees are paying insufficient attention to severance and supplemental retirement benefits. In our experience, compensation committees tend to pay a great deal of attention to these issues, including for example annually reviewing tally sheets that itemize the compensation payable to executives in various termination scenarios. If Treasury's concerns are not directed at the decision-making process, but at the substance of committee decisions about these types of compensation, this principle seems inconsistent with Treasury's stated approach of providing guiding principles rather than prescribing specific forms of pay.

- Alternatively, "we" might refer to the federal government or one or more regulatory agencies in eventual legislation or regulation. This topic is in fact addressed in the recently proposed Shareholder Empowerment Act, which includes a prohibition on "agreements providing for severance payments to a senior executive officer who is terminated because of poor performance as an executive, determined by the board of directors."[18]

As between these interpretations, we think the former is by far the better choice. As repeatedly demonstrated by executive compensation regulation in the past, prohibitions on certain forms of payment frequently have unintended, and often undesirable, consequences for shareholders when compensation committees have to confront the economic realities of attracting and retaining executives. For example, TARP imposed restraints on bonus and incentive compensation, and we have seen a migration of talent from certain TARP-restricted institutions to non-TARP restricted companies.[19] One function of providing generous severance packages is to facilitate management transitions, and significant limits on the practice of providing severance might result in decreased mobility for executives and

[18] Shareholder Empowerment Act. For TARP recipients, EESA already imposes an outright prohibition on golden parachutes. Prior to its amendment by ARRA, EESA prohibited TARP recipients from paying golden parachutes in excess of three times the executive's base compensation. EESA, Pub. L. No. 110-343, §§ 111(b)(2)(C), 302(b), *amended by* ARRA (2009). The current version of the statute, as amended by ARRA, goes even further, prohibiting TARP recipients from making "any payment to a senior executive officer for departure from a company for any reason, except for payments for services performed or benefits accrued." EESA §§ 111(a)(2), 111(b)(3)(C).

[19] *See, e.g.*, Christine Harper and Josh Fineman, *Mack, Lewis Blame Pay Limits for Executive Departures*, *at* http://www.bloomberg.com/apps/news?pid=20601087&sid=a6rcdwyHYOe0 (April 29, 2009) (quoting Bank of America CEO Ken Lewis as stating that the company had "lost strong revenue generators over the past three months to competitors that are not facing the same compensation restrictions that we are").

less flexibility for public companies and their boards to manage succession among senior personnel.

In sum, we question whether the inclusion of this principle in the Principles is consistent with Treasury's stated intention to avoid endorsement of pay caps and the like.

Principle Five**:** **"[W]e should promote transparency and accountability in the process of setting compensation."**

Part of the rationale behind this principle, Treasury explains, is that "[m]any of the compensation practices that encouraged excessive risk-taking might have been more closely scrutinized if compensation committees had greater independence and shareholders had more clarity."

Compensation Committee Independence

Treasury states in the Principles that it "will propose legislation giving the SEC the power to ensure that compensation committees are more independent, adhering to standards similar to those in place for audit committees as part of the Sarbanes-Oxley Act. At the same time," the Principles provide, "compensation committees would be given the responsibility and the resources to hire their own independent compensation consultants and outside counsel." While we believe that this principle is laudable, we have serious concerns about the manner in which it may be implemented and whether it is redundant with existing regulation.

The Compensation Committee Fact Sheet breaks down these independence considerations as follows:

(i) "The new requirements will mandate that each member of the compensation committee meet, in addition to the current independence standards of the major exchanges, independence requirements similar to those for audit committee members under Sarbanes-Oxley."

The Sarbanes Oxley Act of 2002 ("SOX") requires that, to be considered independent, audit committee members must neither: (a) accept consulting, advisory or compensatory fees from the issuer or its subsidiaries nor (b) be an "affiliated person" of the issuer or any of its subsidiaries (provided that the SEC can exempt a particular relationship from these requirements if it determines that doing so is "appropriate in light of the circumstances").[20] These conditions are interpreted very broadly in the implementing regulations.[21]

If SOX's audit committee independence definition were applied to the compensation committee, it would simply increase an already lengthy list of independence standards

[20] SOX § 301.
[21] Rule 10A-3 under the Exchange Act.

currently required of a public company compensation committee. In addition to stock exchange rules and Delaware and other state law which each include different definitions of director independence that apply to directors generally, U.S. public company compensation committee members are also subject to independence standards under Section 162(m) of the Code and Section 16 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which differ both from each other and from all of the others. We question whether an approach involving five different standards for independence, each with its own intricate set of rules, exceptions, guidelines, ownership tests, business relationship requirements, etc., will improve deliberations about executive pay packages or, indeed, is a constructive contribution to public company governance at all.

Aside from the actual definition of director independence, it is unclear from the Principles and the Compensation Committee Fact Sheet the extent to which the compensation committee requirements will mirror the provisions of SOX.

- Unlike the current New York Stock Exchange ("NYSE") compensation committee independence rules, the SOX audit committee independence rules apply not only to U.S. public companies, but also to listed foreign private issuers and public debt filers, albeit with certain exceptions. Applying additional independence standards to compensation committees of these companies seems unnecessary, not to mention overreaching. We note that such companies are not subject to the independence requirements of Section 16 of the Exchange Act, Section 162(m) of the Code or the stock exchange rules governing compensation committees for the reason that the US historically has deferred to home country regulation of compensation and corporate governance matters. We see no compelling reason for the US to change this policy now.

- SOX requires each public company either to disclose that it has at least one "financial expert" on its audit committee or to explain why it does not.[22] A financial expert is defined as an individual having certain substantive knowledge about financial matters, which he or she must have gained through certain types of relevant experience.[23] While in the audit committee context, clear rules for financial

[22] SOX § 407. Similarly, Section 303A.07(a) of the NYSE Listed Company Manual requires that "at least one member of the audit committee must have accounting or related financial management expertise, as the listed company's board interprets such qualification in its business judgment."

[23] An "audit committee financial expert" is defined as a person with the following attributes: (1) "[a]n understanding of generally accepted accounting principles and financial statements," (2) "[t]he ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves," (3) "[e]xperience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities," (4) "[a]n understanding of internal controls and procedures for financial reporting" and (5) "[a]n understanding of audit committee functions." The financial expert must have acquired this experience in one or more of the following ways: (1) "[e]ducation and experience as a principal financial officer, principal accounting officer, controller, public

reporting exist, it is difficult to imagine how one would frame the same sort of requirements in the context of compensation design and implementation. Based on Treasury's silence on this issue, and given the difficulty of formulating any such substantive knowledge and experience requirements for a compensation committee member, we assume that the forthcoming compensation committee independence legislation will not include any such requirements.[24]

(ii) "Just as Sarbanes-Oxley gave audit committees the power to retain and dismiss outside auditors, the new requirements would enable compensation committees to use outside advisers in the process of setting executive pay:"

(a) "The compensation committee will be directly responsible for the appointment, compensation, retention and oversight of the work of any compensation consultants that it retains, and these compensation consultants must report directly to the compensation committee."

(b) "The compensation committee must have the authority to engage counsel and other advisers, as it determines necessary to carry out its duties."

(c) "Each company must provide for 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."

This item does not expressly mandate compensation committees to retain any consultants, counsel or advisers. With respect to consultants, companies listed on the NYSE are already required to include in their compensation committee charters the responsibilities and authority described above.[25] We assume this item is intended merely to identify this

accountant or auditor or experience in one or more positions that involve the performance of similar functions," (2) "[e]xperience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions," (3) "[e]xperience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements" or (4) "[o]ther relevant experience."

[24] The SEC Proposed Amendments call for increased disclosure for each director and director nominee about "the particular experience, qualifications, attributes or skills that qualify that person to serve as a director of the company, and as a member of any committee that the person serves on or is chosen to serve on, in light of the company's business." Sean Harrison, Special Counsel, SEC, "Speech by SEC Staff: Division Statement before the Commission Open Meeting: Proxy Disclosure and Solicitation Enhancements" (July 1, 2009). However, there is no indication of a particular focus on compensation committee members and, while disclosure requirements may drive practice, the requirement is still just descriptive and not prescriptive.

[25] The commentary following Section 303A.05 of the NYSE Listed Company Manual states that "if a compensation consultant is to assist in the evaluation of director, CEO or executive officer compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms." The Shareholder Empowerment Act would require the same for all public companies.

arrangement as a best practice for compensation committees. We note that public companies not subject to NYSE's compensation committee requirements should review their compensation committee charters for compliance with this item generally, and all public companies (whether or not NYSE listed) should review their charters to ensure that the authority granted to the committee is sufficient to retain not only consultants, but also legal counsel and other advisers. We believe the compensation committee's ability to hire its own advisers to ensure that it has a source of information unbiased by management's selection of the compensation adviser will permit it an unfiltered view of compensation matters. Compensation committees should review their processes with this in mind.

(iii) "The new requirements will direct the SEC to establish standards for ensuring the independence of compensation consultants and outside counsel used by the compensation committee."

As with the other items listed above, this item does not appear to require the compensation committee to hire compensation consultants or outside counsel. It simply states that any such consultants and counsel whose services the committee uses must be independent. The Principles do not provide any parameters for the standards to be established.

Any independence requirements for compensation consultants and outside counsel should be crafted with care to avoid imposing additional burdens that do not meaningfully improve the quality of a company's overall process for determining executive pay. For example, pursuant to the recently issued regulations under EESA, TARP recipients' compensation committees are required to disclose annually to Treasury and the company's primary regulator whether the company, the board or the committee "has engaged a compensation consultant; and all types of services . . . the compensation consultant or any of its affiliates has provided to the TARP recipient, the board, or the compensation committee during the past three years . . . ."[26] "TARP recipient" is defined to include both the parent company and all direct and indirect majority-owned subsidiaries. If, for purposes of the compensation consultant and/or outside counsel independence requirements, each of the company and the consultant were similarly defined:

- Compliance with the rule would require extensive data gathering that the company probably would not otherwise perform (i.e., identification of all of the company's and the consultant's relevant affiliates and of relationships between the company or any of its relevant affiliates on one hand, and the counsel or consultant or any of its relevant affiliates on the other hand).

- Compliance would also require a process for constant updating of this information. For example, unbeknownst to the company, its affiliate in India might decide to hire an actuarial firm affiliated with a compensation committee consultant, inadvertently

[26] Prop. Treas. Reg. § 30.11(c), 74 Fed. Reg. 28,393, 28,417 (June 15, 2009), *available at* http://edocket.access.gpo.gov/2009/E9-13868.htm.

> calling into question the consultant's independence. Alternatively, an affiliate of the compensation committee's consultant may acquire a subsidiary of the company's actuarial firm. The impact of consolidation among compensation consultants in a highly fragmented industry could be significant. For example, the impending merger of Towers Perrin and Watson Wyatt,[27] two major human-resources consulting firms, likely will cause their compensation committee clients to rethink their relationships in light of possible perceptions of conflicts of interest.

The SEC Proposed Amendments would require increased disclosure of potential compensation consultant conflicts of interest, including a description of the services provided by the consultant and its affiliates with respect to executive and director compensation and unrelated services, together with the aggregate fees paid for each set of services. In addition, the identity of those involved in the decision by the company to use the consultant or any of its affiliates for services would be disclosed and, if management was involved, the disclosure would have to state whether the board of directors approved the decision. While the details of the proposed requirements are not yet public, it appears that the SEC may be proposing to cast over all U.S. public companies the same broad disclosure net to which TARP recipients are now subject.

In addition, while the SEC has repeatedly stated that it does not seek to change company practice through its disclosure requirements, the proposed disclosure regarding board approval of services (or lack thereof) will likely drive public companies to adopt policies for the review and pre-approval of services provided by compensation consultants. The rules pertaining to auditor independence introduced by SOX[28] utilize such a pre-approval mechanism for non-audit related services, providing the audit committee with a means to monitor such services provided by the auditor in order to ensure that they are compatible with the auditor's independence from management. However, while this approach provides flexibility with respect to one possible type of conflict of interest, the independent auditor rules under SOX are extensive and unnecessarily prohibitive when applied in the context of compensation matters as opposed to financial reporting.

Some may suggest that this type of prescriptive independence framework has been workable (although not without significant challenges) in the area of independent auditors. But we

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[27] *See* Jeffrey McCracken and Joann S. Lublin, *Towers Perrin and Watson Wyatt to Merge*, WALL ST. J. (June 29, 2009), *at* http://online.wsj.com/article/SB124623144442366139.html.

[28] Item 2-01 of Regulation S-X sets forth restrictions on financial, employment and business relationships between an accountant and an audit client, and restrictions on an accountant providing certain non-audit services to an audit client. For example, an accountant cannot have a direct or indirect financial interest in an audit client, a prohibition that applies not only to all covered persons at the accounting firm, but also to the accountant's immediate family members (e.g., such individuals cannot have a direct investment or material indirect investment in the audit client). Similarly, an accountant is not independent if the accounting firm, any covered person in the firm, or any of his or her immediate family members has made a loan to, or received a loan from, an audit client, subject to a number of exceptions. These are just two examples from a litany of requirements detailing the standards for auditor independence.

question whether similarly rigorous standards are appropriate in the case of compensation advisers whose work and work product do not entail the kinds of systemic fraud and other risks sought be countered by the framework applicable to auditors. We fear a definition of independence that in this context would be yet another example of "ghosts and shadows" regulation (i.e., regulation designed to address regulators' fears by shining light in every conceivable dark corner of the room hunting apparitions that are not there), with the result that compliance is time-consuming, recordkeeping is voluminous and the resulting benefits are *de minimis*.

We believe that decisions about the retention of compensation consultants and outside counsel should remain the purview of boards and compensation committees, who are already well equipped to determine whether they believe a given consultant or counselor can provide unbiased advice uninfluenced by management. There are numerous examples of compensation committees with fully independent consultants that entered into arrangements that were later criticized, and committees with consultants who are not fully independent (within the meaning of the auditor independence rules) that have not been subject to the same type of criticism. What is critical is that compensation committees take full responsibility for the compensation-setting process. The question that committee members must answer is whether an adviser has any relationships that will impair its ability to provide unbiased advice without regard to management's perspective. Legislative and regulatory initiatives about independence cannot answer this question for the committee, but they can provide investors with false assurance about the quality of the committee's deliberations and therefore should be considered with caution and a healthy dose of skepticism.

Say on Pay

Also in its effort to address issues of transparency and accountability in the process of setting compensation, Treasury states that it intends to support Congressional efforts to "pass 'say on pay' legislation, giving the SEC authority to require companies to give shareholders a non-binding vote on executive compensation packages."[29]

Indeed, the Say on Pay Fact Sheet indicates that the SEC will be authorized "to require non-binding say-on-pay votes," not only for financial institutions, but "for *all* public companies" [emphasis added].[30] Four types of votes are described:

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[29] The Shareholder Empowerment Act would require public companies to give shareholders a say on pay vote "to approve the compensation of senior executive officers, as disclosed pursuant to the compensation disclosure rules of the Commission . . . ." Senator Schumer's proposed Shareholder Bill of Rights Act of 2009 would also require an annual vote on executive compensation. S. 1074, 111th Cong. (2009).

[30] The Principles do not make clear whether the administration means such legislation to apply to foreign private issuers subject to the Exchange Act. The bills proposed by Congressman Peters and Senator Schumer, as currently written, would impose such legislation on foreign private issuers. We believe that this would be a radical and unwarranted departure from the United States' historic deference to home country corporate governance and proxy solicitation rules, and could invite counterproductive retaliation by foreign governments.

(i) "All public companies will have to include in annual proxy statements a shareholder resolution requesting approval or disapproval of executive compensation as disclosed in the proxy, including the narrative description of the board's compensation decisions in the Compensation Discussion and Analysis and the quantitative disclosure of amounts executives are entitled to receive."

(ii) "Shareholders, as the owners of the company, will have the right to vote on annual compensation for the top five named executive officers as disclosed in the company's proxy statement . . . . The types of compensation shareholders will have the opportunity to evaluate are described in the CD&A, including the following items disclosed in the summary compensation table: salary, bonus, stock awards, option awards, non-equity incentive plan compensation, change in pension value and non-qualified deferred compensation earnings, all other compensation and total compensation amount."

The distinction Treasury is trying to draw between the vote described in item (i) and the vote described in item (ii) is a matter of speculation at best. These items could be read to suggest that Treasury intends for shareholders to vote under item (i) on whether they approve the firm's compensation philosophy and the overall design of its executive compensation program, and under item (ii) on whether they approve the actual compensation paid to the company's named executive officers. That said, item (i) also appears to address the amount of compensation paid to executives, and item (ii) leaves room for the possibility that it is intended to address compensation beyond the items disclosed in the summary compensation table.[31] We hope that the SEC will clarify all of these issues in its implementing regulations.[32]

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[31] Item (ii) refers to items "described in the CD&A, *including* the following items disclosed in the summary compensation table" [emphasis added].

[32] As noted above, the SEC's TARP Say on Pay Proposed Rule, issued on July 2, 2009, sets forth regulations regarding the say on pay vote that TARP recipients are required to hold under EESA. The proposed regulations closely follow the language of EESA § 111(e) (requiring that the TARP recipient "shall provide a separate shareholder vote to approve the compensation of executives, as disclosed pursuant to Item 402 of Regulation S-K . . . including the compensation discussion and analysis, the compensation tables, and any related material"). TARP Say on Pay Proposed Rule at 19. It is not clear the extent to which the administration might follow the TARP Say on Pay Proposed Rule when establishing say on pay rules for public companies generally. It is interesting to note, however, that such Proposed Rule does not prescribe specific language or a particular form of resolution for a say on pay vote and that TARP recipients will be required to file a preliminary proxy statement whenever a say on pay vote is included. *Id.* at n.14, 7 (noting that the SEC is "not proposing to amend Rule 14a-6 at this time to add the vote required for TARP recipients to the list of items that do not trigger a preliminary filing"). In terms of the substance of the required vote, the TARP Say on Pay Proposed Rule clarifies that a vote "to approve only compensation policies and procedures[] would not satisfy the requirements of" EESA or the proposed rule. *Id.* at n.14. Interestingly, at least one of the SEC commissioners expressed doubt during the open meeting regarding the efficacy and appropriateness of the statutorily required say on pay votes for TARP recipients.

(iii) "Companies will have the opportunity to ask shareholders' views on specific compensation decisions, including decisions related to various aspects or categories of pay."

It appears that, unlike the other three types of votes, the votes described in this item (iii) will be permissive rather than mandatory. Since companies could presumably elect to include such an item in their proxy statements currently, we assume that this item is intended to suggest and/or encourage the practice.

(iv) "[S]hareholders will have the opportunity to cast a non-binding vote to approve or disapprove golden parachute compensation disclosed in proxy solicitation materials prepared for shareholder meetings relating to a merger, acquisition, or other transaction that may involve a change in control of the corporation."

The effectiveness of the vote described in this item (iv) is unclear, given that the vote will occur in the context of an impending transaction where change-in-control agreements are already in place and the parachute payments under those agreements are about to be triggered.[33]

We believe that the wisdom and utility of requiring any of the votes described above is questionable in light of considerations such as the following:

- In the Say on Pay Fact Sheet, Treasury states that several companies have voluntarily implemented say on pay votes, "[r]ecognizing that say-on-pay permits directors to benefit from shareholder perspectives in designing compensation . . . ." However, it neglects to point out that with very few exceptions, such votes were implemented as a result of specific shareholder pressure, including through shareholder proxy proposals, and not as a result of a decision as to their efficacy.

- It is difficult to see how the annual votes will allow shareholders to impart meaningful information to directors about their perspectives on compensation design. To the extent shareholders read and understand the compensation disclosure and develop ideas for how aspects of the firm's compensation programs might be improved, yea or nay votes wholly to approve or reject the firm's overall executive compensation philosophy and program and compensation packages for the firm's named executive officers do not seem a particularly helpful medium through which shareholders might express those opinions.

- Even in the current environment, with the public inflamed and ready to blame executive compensation practices for the recent problems in the financial industry,

[33] Senator Schumer's proposed Shareholder Bill of Rights Act of 2009 would also require such a vote on golden parachutes.

we are not aware of a single TARP recipient whose shareholders rejected the company's say on pay vote this year. If a TARP recipient's shareholders are dissatisfied with the company's compensation practices, the say on pay vote certainly did not serve to communicate that dissatisfaction.

- Treasury further states in the Say on Pay Fact Sheet that, "[a]lthough the results of the vote under our proposed legislation would not be binding on the board, shareholder votes have led to significant changes, and experience shows that the prospect of the vote itself can cause directors more carefully to consider shareholder interests when designing executive pay." While say on pay voting requirements may provide some encouragement for boards to take care in designing compensation programs, all of the other Principles – as well as the requirements under EESA, Treasury's agreements with TARP recipients and the various sets of compensation principles and guidelines that have recently been developed by governments and organizations around the world – generally encourage the same result. This reason alone hardly seems a sufficient justification for requiring all public companies to include multiple say on pay resolutions in their annual proxy statements.

- Say on pay supporters, including Treasury, look to Europe, and especially the UK, as an example where say on pay voting has worked well.[34] However, business cultures differ and what seems appropriate for companies and shareholders in the UK would not necessarily work for U.S. companies and shareholders with different aims and philosophies.

- Unlike compensation committees, individual shareholders are not bound to act in the best interests of the company and all of its shareholders, and could use the say on pay vote as a means to advance non-economic personal or social agendas.

- Lastly, unless current voting practices change significantly, the number of shareholders whose perspectives might arguably be voiced through these votes likely could be quite limited. Institutional shareholders and organizations such as the former Institutional Shareholder Services ("ISS," now part of the RiskMetrics Group), together with a small number of activist investors, now dominate the proxy voting process.[35] Retail investor turnout for proxy voting – historically low – has

[34] *See, e.g.*, *Principles, not pitchforks*, ECONOMIST (June 11, 2009), *available at* http://www.economist.com/businessfinance/displaystory.cfm?story_id=13837408 (stating that "[e]xperience in Europe, where [say on pay] ballots are common, has shown they encourage boards to consult more actively with shareholders on pay issues ahead of formal polls").
[35] *See, e.g.*, Press Release, The Conference Bd., U.S. Institutional Investors Continue to Boost Ownership of U.S. Corporations (Jan. 22, 2007), *at* http://www.conference-board.org/utilities/pressDetail.cfm?press_ID=3046 ; Kaja Whitehouse, *Investor Activism Tops Last Year's Record Pace*, WALL ST. J. (Feb. 16, 2008), *at* http://online.wsj.com/article/SB120313088934873479.html.

seen even greater decline in recent years.[36] This outcome could be further exacerbated if the change from "routine" status to "non-routine" status under New York Stock Exchange ("NYSE") Rule 452[37] for uncontested director elections[38] were ever extended to cover say on pay votes as well. It is unlikely that having compensation decisions for all U.S. companies be funneled through a few filtering organizations is to anyone's benefit.

Taking a step back, we question the efficacy of the current intense governmental focus on regulation of executive compensation. The long history of regulation in the area has proven that achieving policy objectives through regulation is difficult, at best. Corporate governance generally has experienced, and continues to experience, significant marketplace and legal pressures for effective evolution. We believe that these forces are sufficient to address any problems, without the need for additional mandates. Accordingly, in our view, less government is more in the current environment.

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Please contact any of the lawyers listed in the Corporate Governance or Employee Benefits section of our website (www.cgsh.com) or any of your other regular contacts at the firm for further information about the matters discussed above.

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[36] According to an article posted on RiskMetrics' Risk & Governance Blog, among firms that have adopted "notice and access" e-proxy filing, "only 4.5 percent of individual investors voted . . . in late 2007 and early 2008, down from 19.2 percent participation in late 2006 and early 2007 . . . ." L. Reed Walton, *E-Proxy: Retail Voting Still Low*, *available at* http://blog.riskmetrics.com/proxy_voting/ (May 19, 2008). While this drop in individual investor voting could be due in part to these firms' switch to e-proxy filing (which was first permitted in July 2007), even the pre-e-proxy numbers illustrate the lack of retail investor participation.

[37] NYSE Listed Company Manual § 452 (2003). Note that because Rule 452 applies to brokers, it affects public companies whether or not they are listed on the NYSE.

[38] Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Listed Company Manual Section 402.08, Exchange Act Release No. 59,464, 74 Fed. Reg. 9,862 (March 6, 2009), *available at* http://www.sec.gov/rules/sro/nyse/2009/34-59464.pdf. The SEC approved the amendment at its July 1, 2009 open meeting. For more information, see our July 1, 2009 memorandum entitled "Responding to Elimination of Broker Discretionary Voting in Elections of Directors," *available at* http://www.cgsh.com/responding_to_elimination_of_broker_discretionary_voting_in_elections_of_directors/.

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