CLEARY GOTTLIEB Alert Memo

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Summary of the Corporate and Financial Institution Compensation Fairness Act of 2009

The House Financial Services Committee will mark up H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009 (the "Bill"), on Tuesday, July 28. Attached as Appendix A is a copy of the current version of the Bill. The Bill is expected to go to the House floor by Friday, July 31. The Bill reflects certain proposals on which the Chairman of the Committee, Representative Barney Frank, has spoken frequently in the past, two of which were also addressed in Treasury Secretary Geithner's recent statement concerning compensation principles.[1]

Specifically, the Bill addresses the following topics:

1. Advisory shareholder votes on executive compensation on an annual basis ("say on pay" votes) and in connection with certain acquisition transactions;

2. Compensation committee independence; and

3. Financial institution incentive compensation plan design.

The provisions have different proposed effective dates. The shareholder vote provision is proposed to be effective six months after the Securities and Exchange Commission ("SEC") issues final regulations implementing the provision. The SEC is directed to promulgate those regulations within six months after enactment of the Bill into law. Accordingly, it seems unlikely that the Bill's new requirements concerning annual say on pay votes would be effective for the 2010 proxy season. The provisions concerning compensation committee independence and financial institution incentive compensation plan designs require regulators to issue rules or regulations that would implement those provisions not later than 270 days after the enactment of the Bill into law.

[1] The statement can be found at http://www.ustreas.gov/press/releases/tg163.htm. See also our memorandum entitled "Treasury's Take on Executive Compensation: It's a Matter of Principles," which can be found at http://www.cgsh.com/treasurys_take_on_executive_compensation_its_a_matter_of_principles/ (the "Principles Memorandum"). The statement included proposals concerning "say on pay" and compensation committee independence. Treasury then followed up on July 16, 2009 with fact sheets and proposed legislative language with respect to these issues, which are available at http://www.ustreas.gov/press/releases/tg218.htm and http://www.ustreas.gov/press/releases/tg219.htm.

This note briefly summarizes the provisions of the Bill. Following the summaries, we discuss the potential applicability of the provisions to companies other than U.S. public companies, including "foreign private issuers"[2] and the U.S. operations of non-U.S. financial institutions.[3]

1. Advisory Shareholder Votes on Executive Compensation

Section 2 of the Bill, concerning advisory shareholder votes on executive compensation, has two parts. The first part would mandate annual say on pay votes. Under the provision, companies would be required to give shareholders an annual opportunity to cast a separate non-binding advisory vote to approve the compensation of executives as disclosed pursuant to the SEC's compensation disclosure rules (including the compensation committee report, the compensation discussion and analysis, the compensation tables, and any related materials).

The second part of Section 2 also mandates a separate non-binding advisory vote on compensation, in the context of acquisition transactions. Specifically, the second part mandates a vote on certain acquisition transaction-related compensation (colloquially, "golden parachute payments").[4] The provision requires disclosure in a clear and simple tabular form concerning each item of such compensation that has not previously "been subject to" a say on pay shareholder vote, and the "aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable." The provision raises a host of technical and interpretive issues, as well as obvious questions about the potential practical impact of such a vote. Any assessment with respect to the latter question would seem largely futile until further interpretive clarification becomes available.

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[2] Generally, a "foreign private issuer" is a non-governmental entity formed under the laws of a non-U.S. jurisdiction, unless more than half of its shareholders are U.S. persons and either the majority of its executives are U.S. persons, a majority of its assets are located in the U.S. or its business is principally administered in the U.S. See Rule 3b-4 under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

[3] See also our note entitled "Frank Bill Purports to Regulate Incentive Compensation of Fund Sponsors," concerning the potential impact of the Bill on managers of private investment funds, which can be found at http://www.cgsh.com/frank_bill_purports_to_regulate_incentive_compensation_of_fund_sponsors/ (the "Fund Sponsor Note").

[4] The Bill requires such a vote in connection with any proxy or consent solicitation for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting) that concerns an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of an issuer. The type of compensation covered by the Bill is "any type of compensation (whether present, deferred, or contingent) that is based on or otherwise relates to the acquisition, merger, consolidation, sale, or other disposition of all or substantially all of the assets of the issuer," payable to "any principal executive officers of such issuer (or of the acquiring issuer, if such issuer is not the acquiring issuer)" if there is any agreement or understanding between the person making the proxy or consent solicitation and such executive officer concerning such compensation.

2. Compensation Committee Independence

Section 3 of the Bill directs the SEC to require the national securities exchanges and national securities associations to adopt new listing requirements relating to compensation committee independence. The new rules would largely (and intentionally) parallel the independence requirements for audit committee members imposed by the Sarbanes-Oxley Act of 2002, as amended ("SOX"). As noted in the Principles Memorandum, most U.S. public companies are already subject to four separate sets of rules concerning compensation committee independence,[5] and the marginal benefit that could reasonably be expected to result from a fifth set of rules seems quite small.

Section 3 also provides that:

- compensation consultants, legal counsel and other advisors to compensation committees must meet such standards for independence as may be established by the SEC[6];
- compensation committees must have exclusive discretionary authority to retain and obtain the advice of compensation consultants, counsel and other advisors meeting the standards for independence promulgated by the SEC, as well as responsibility for the appointment, compensation, and oversight of the work of any such independent compensation consultants;
- annual proxy statements must include disclosure concerning whether compensation committees obtained advice from independent compensation consultants, with an explanation of their failure to do so if that is the case;
- issuers must provide funding for such independent consultants, counsel and advisors; and
- the SEC must conduct a study concerning the impact of its new independence standards, and report on the results to Congress within two years.

While a definitive assessment of the impact of these additional provisions will have to await additional guidance from the SEC about the standards to be imposed, it seems likely that the

[5] Listing standards, state corporate law, standards imposed by Rule 16b-3 under the Exchange Act, and standards imposed under Section 162(m) of the Internal Revenue Code of 1986, as amended.

[6] See also our memorandum entitled "SEC Releases Proposed Disclosure Rule Changes for Compensation Program Risk, Compensation Consultant Independence and Equity-Based Compensation Awards," which can be found in the News and Publications section of our website at: www.cgsh.com. The rule changes proposed by the SEC on July 10, 2009, and described in that memorandum impose new disclosure requirements, but not specific qualification requirements, relating to the independence of compensation consultants.

import of these additional provisions will lie less in the substance of the new independence standards than in what their inclusion in the Bill suggests about the current regulatory focus on the issue of executive compensation.

3. Financial Institution Compensation Plan Design

Section 4 of the Bill provides for regulatory review and oversight of incentive compensation plan design for financial institutions. The regulators to which authority and responsibility for such review and oversight is granted are the Federal Reserve Board, the Office of the Comptroller of the Currency, the Board of Directors of the FDIC, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board and the SEC. The types of financial institutions subject to such review and oversight include depositary institutions and depositary institution holding companies, broker-dealers, investment advisers[7], credit unions and any other type of financial institution that the regulators determine.

More specifically, Section 4 requires that the regulators jointly prescribe regulations to require each covered financial institution to disclose to them "the structures of the incentive-based compensation arrangements for officers and employees of such institution" so that the regulators may determine whether the compensation structure "(1) is aligned with sound risk management; (2) is structured to account for the time horizon of risks; and (3) meets such other criteria" as the regulators jointly may determine to be appropriate to "reduce unreasonable incentives for officers and employees to take undue risks that (A) could threaten the safety and soundness of covered financial institutions; or (B) could have serious adverse effects on economic conditions or financial stability."

Section 4 also requires that, taking into account the foregoing factors, the regulators jointly prescribe regulations to prohibit any compensation structure or incentive-based payment arrangement, or any feature of such compensation structure or arrangement, which they determine would encourage such destabilizing undue risks by the institutions, officers or employees.

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Among the significant ambiguities in the Bill is the question of whether its provisions would apply to non-U.S. issuers. The considerations related to this question are different for each of the different substantive provisions of the Bill, as follows:

- Foreign private issuers are generally not subject to the rules concerning the solicitation of proxies that apply to U.S. public companies. Among other things, the executive compensation disclosure requirements applicable to

[7] As drafted, this provision would apply to all investment advisors, whether or not registered under the Investment Advisers Act of 1940. See our Fund Sponsor Note.

U.S. public companies generally do not apply to foreign private issuers. It is therefore incongruous, and in our view likely an oversight, that the shareholder approval provisions contained in Section 2 of the Bill would appear to apply to foreign private issuers.[8]

- As noted above, the compensation committee independence provisions of Section 3 of the Bill parallel the independence requirements for audit committees imposed by SOX. The SOX rules were made applicable to foreign private issuers, and it seems likely therefore that the requirements of Section 3 of the Bill would also apply to foreign private issuers, if the Bill were to be enacted substantially as proposed. In our view, however, the analogy between audit committees and compensation committees in respect of independence issues is less than persuasive, and we believe that the extension of the proposed compensation committee independence requirements to foreign private issuers is unnecessary and unwarranted.

- The mandate to regulators concerning review of incentive compensation plan designs does not address whether oversight should extend to non-U.S. institutions. We note that non-U.S. institutions may be subject to extensive home country "safety and soundness" regulation, and that U.S. regulatory oversight of the U.S. operations of non-U.S. financial institutions is generally substantially more limited than for U.S. institutions. We do not believe that the specific issue of incentive compensation design raises concerns of such critical importance, relative to other regulatory concerns, that would merit the high level of regulatory oversight suggested by Section 4 of the Bill on the U.S. operations of non-U.S. financial institutions.

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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.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

[8] Rule 3a-12 under the Exchange Act exempts foreign private issuers from listed subsections of Section 14 of the Exchange Act. The list of exclusions does not, of course, include proposed new Section 14(i) that would be added by the Bill if it were to be enacted in its current form.

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111TH CONGRESS
1ST SESSION

H. R. 3269

To amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation and to prevent perverse incentives in the compensation practices of financial institutions.

IN THE HOUSE OF REPRESENTATIVES

JULY 21, 2009

Mr. FRANK of Massachusetts (for himself, Mr. PETERS, Ms. KILROY, Mr. WATT, Mr. CAPUANO, Mr. AL GREEN of Texas, Mr. SHERMAN, Mr. CARSON of Indiana, Mr. GUTIERREZ, Mr. ELLISON, and Mr. HINOJOSA) introduced the following bill; which was referred to the Committee on Financial Services

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A BILL

To amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation and to prevent perverse incentives in the compensation practices of financial institutions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the ''Corporate and Financial Institution Compensation Fairness Act of 2009''.

SEC. 2. SHAREHOLDER VOTE ON EXECUTIVE COMPENSATION DISCLOSURES.

Section 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) is amended by adding at the end the following new subsection:

''(i) ANNUAL SHAREHOLDER APPROVAL OF EXECUTIVE COMPENSATION.—

''(1) ANNUAL VOTE.—Any proxy or consent or authorization for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting) occurring on or after the date that is 6 months after the date on which final rules are issued under paragraph (3), shall provide for a separate shareholder 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, the compensation discussion and analysis, the compensation tables, and any related materials). The shareholder vote shall not be binding on the corporation or the board of directors and shall not be construed as overruling a decision by such board, nor to create or imply any additional fiduciary duty by such board, nor shall such vote be construed to restrict or limit the ability of shareholders to make proposals for in-

clusion in such proxy materials related to executive compensation.

''(2) SHAREHOLDER APPROVAL OF GOLDEN PARACHUTE COMPENSATION.—

''(A) DISCLOSURE.—In any proxy or consent solicitation material for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting) occurring on or after the date that is 6 months after the date on which final rules are issued under paragraph (3), that concerns an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of an issuer, the person making such solicitation shall disclose in the proxy or consent solicitation material, in a clear and simple tabular form in accordance with regulations to be promulgated by the Commission, any agreements or understandings that such person has with any principal executive officers of such issuer (or of the acquiring issuer, if such issuer is not the acquiring issuer) concerning any type of compensation (whether present, deferred, or contingent) that is based on or otherwise relates to the acquisition, merger, consolidation, sale, or

other disposition of all or substantially all of the assets of the issuer that have not been subject to a shareholder vote under paragraph (1), and the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer.

''(B) SHAREHOLDER APPROVAL.—Any proxy or consent or authorization relating to the proxy or consent solicitation material containing the disclosure required by subparagraph (A) shall provide for a separate shareholder vote to approve such agreements or understandings and compensation as disclosed. A vote by the shareholders shall not be binding on the corporation or the board of directors of the issuer or the person making the solicitation and shall not be construed as overruling a decision by such board, nor to create or imply any additional fiduciary duty by such board, nor shall such vote be construed to restrict or limit the ability of shareholders to make proposals for inclusion in such proxy materials related to executive compensation.

''(3) RULEMAKING.—Not later than 6 months after the date of the enactment of the Corporate and Financial Institution Compensation Fairness Act of 2009, the Commission shall issue rules and regulations to implement this subsection.''.

SEC. 3. COMPENSATION COMMITTEE INDEPENDENCE.

(a) STANDARDS RELATING TO COMPENSATION COMMITTEES.—The Securities Exchange Act of 1934 (15 U.S.C. 78f) is amended by inserting after section 10A the following new section:

''SEC. 10B. STANDARDS RELATING TO COMPENSATION COMMITTEES.

''(a) COMMISSION RULES.—

''(1) IN GENERAL.—Effective not later than 270 days after the date of enactment of the Corporate and Financial Institution Compensation Fairness Act of 2009, the Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of any portion of subsections (b) through (f).

''(2) OPPORTUNITY TO CURE DEFECTS.—The rules of the Commission under paragraph (1) shall provide for appropriate procedures for an issuer to

have an opportunity to cure any defects that would be the basis for a prohibition under paragraph (1) before the imposition of such prohibition.

''(3) EXEMPTION AUTHORITY.—The Commission may exempt certain categories of issuers from the requirements of subsections (b) through (f), where appropriate in view of the purpose of this section. In determining appropriate exemptions, the Commission shall take into account, among other considerations, the potential impact on smaller reporting issuers.

''(b) INDEPENDENCE OF COMPENSATION COMMITTEES.—

''(1) IN GENERAL.—Each member of the compensation committee of the board of directors of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

''(2) CRITERIA.—In order to be considered to be independent for purposes of this subsection, a member of a compensation committee of an issuer may not, other than in his or her capacity as a member of the compensation committee, the board of directors, or any other board committee—

''(A) accept any consulting, advisory, or other compensatory fee from the issuer; or

"(B) be an affiliated person of the issuer or any subsidiary thereof.

"(C) EXEMPTIVE AUTHORITY.—The Commission may exempt from the requirements of paragraph (2) a particular relationship with respect to compensation committee members, where appropriate in view of the purpose of this section.

"(3) DEFINITION.—As used in this section, the term 'compensation committee' means—

"(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of determining and approving the compensation arrangements for the executive officers of the issuer; and

"(B) if no such committee exists with respect to an issuer, the independent members of the entire board of directors.

"(c) INDEPENDENCE STANDARDS FOR COMPENSATION CONSULTANTS AND OTHER COMMITTEE ADVISORS.—Any compensation consultant, legal counsel, or other adviser to the compensation committee of any issuer shall meet standards for independence established by the Commission by regulation.

''(d) COMPENSATION COMMITTEE AUTHORITY RELATING TO COMPENSATION CONSULTANTS.—

''(1) IN GENERAL.—The compensation committee of each issuer, in its capacity as a committee of the board of directors, shall have the authority, in its sole discretion, to retain and obtain the advice of a compensation consultant meeting the standards for independence promulgated pursuant to subsection (c), and the compensation committee shall be directly responsible for the appointment, compensation, and oversight of the work of such independent compensation consultant. This provision shall not be construed to require the compensation committee to implement or act consistently with the advice or recommendations of the compensation consultant, and shall not otherwise affect the compensation committee's ability or obligation to exercise its own judgment in fulfillment of its duties.

''(2) DISCLOSURE.—In any proxy or consent solicitation material for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting) occurring on or after the date that is 1 year after the date of enactment of the Corporate and Financial Institution Compensation Fairness Act of 2009, each issuer shall disclose in the proxy

or consent material, in accordance with regulations to be promulgated by the Commission—

"(A) whether the compensation committee of the issuer retained and obtained the advice of a compensation consultant meeting the standards for independence promulgated pursuant to subsection (c); and

"(B) if the compensation committee of the issuer has not retained and obtained the advice of a compensation consultant meeting the standards for independence promulgated pursuant to subsection (c), an explanation of the basis for the compensation committee's determination that the retention of such an independent consultant was not in the interests of shareholders.

"(e) AUTHORITY TO ENGAGE INDEPENDENT COUNSEL AND OTHER ADVISORS.—The compensation committee of each issuer, in its capacity as a committee of the board of directors, shall have the authority, in its sole discretion, to retain and obtain the advice of independent counsel and other advisers meeting the standards for independence promulgated pursuant to subsection (c), and the compensation committee shall be directly responsible for the appointment, compensation, and oversight of the work

of such independent counsel and other advisers. This provision shall not be construed to require the compensation committee to implement or act consistently with the advice or recommendations of such independent counsel and other advisers, and shall not otherwise affect the compensation committee's ability or obligation to exercise its own judgment in fulfillment of its duties.

''(f) FUNDING.—Each issuer shall provide for appropriate funding, as determined by the compensation committee, in its capacity as a committee of the board of directors, for payment of compensation—

''(1) to any compensation consultant to the compensation committee that meets the standards for independence promulgated pursuant to subsection (c), and

''(2) to any independent counsel or other adviser to the compensation committee.''.

(b) STUDY AND REVIEW REQUIRED.—

(1) IN GENERAL.—The Securities and Exchange Commission shall conduct a study and review of the use of compensation consultants meeting the standards for independence promulgated pursuant to section 10B(c) of the Securities Exchange Act of 1934 (as added by subsection (a)), and the effects of such use.

(2) REPORT TO CONGRESS.—Not later than 2 years after the date of enactment of this Act, the Commission shall submit a report to the Congress on the results of the study and review required by this paragraph.

SEC. 4. ENHANCED COMPENSATION STRUCTURE REPORTING TO REDUCE PERVERSE INCENTIVES.

(a) ENHANCED DISCLOSURE AND REPORTING OF COMPENSATION ARRANGEMENTS.—Not later than 270 days after the date of enactment of this Act, the appropriate Federal regulators jointly shall prescribe regulations to require each covered financial institution to disclose to the appropriate Federal regulator the structures of the incentive-based compensation arrangements for officers and employees of such institution sufficient to determine whether the compensation structure—

(1) is aligned with sound risk management;

(2) is structured to account for the time horizon of risks; and

(3) meets such other criteria as the appropriate Federal regulators jointly may determine to be appropriate to reduce unreasonable incentives for officers and employees to take undue risks that—

(A) could threaten the safety and soundness of covered financial institutions; or

(B) could have serious adverse effects on economic conditions or financial stability.

(b) PROHIBITION ON CERTAIN COMPENSATION STRUCTURES.—Not later than 270 days after the date of enactment of this Act, and taking into account the factors described in paragraphs (1), (2), and (3) of subsection (a), the appropriate Federal regulators shall jointly prescribe regulations that prohibit any compensation structure or incentive-based payment arrangement, or any feature of any such compensation structure or arrangement, that the regulators determine encourages inappropriate risks by financial institutions or officers or employees of covered financial institutions that—

(1) could threaten the safety and soundness of covered financial institutions; or

(2) could have serious adverse effects on economic conditions or financial stability.

(c) ENFORCEMENT.—The provisions of this section shall be enforced under section 505 of the Gramm-Leach-Bliley Act and, for purposes of such section, a violation of this section shall be treated as a violation of subtitle A of title V of such Act.

(d) DEFINITIONS.—As used in this section—

(1) the term ''appropriate Federal regulator'' means—

(A) the Board of Governors of the Federal Reserve System;

(B) the Office of the Comptroller of the Currency;

(C) the Board of Directors of the Federal Deposit Insurance Corporation;

(D) the Director of the Office of Thrift Supervision;

(E) the National Credit Union Administration Board; and

(F) the Securities and Exchange Commission; and

(2) the term ''covered financial institution'' means—

(A) a depository institution or depository institution holding company, as such terms are defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(B) a broker-dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*);

(C) a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act;

(D) an investment advisor, as such term is defined in section 202(a)(11) of the Investment

Advisers Act of 1940 (15 U.S.C. 80b–2(a)(11)); and

(E) any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for purposes of this section.

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