
Corporate Governance and Executive Compensation Reform in 2009 – An Update

Twin Cities Compensation Network

**Society of Corporate Secretaries and Governance
Professionals – Twin Cities Chapter**

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How Did We Get Here?

- ▶ 2009 has been an “eventful” year
 - The blame for the ongoing economic crisis has been placed on lax corporate oversight and poorly-designed compensation programs
 - This perception meshes neatly with the continuing concerns about excessive executive compensation
 - To restore investor confidence in the markets, the Obama Administration and Congress have proposed several reforms to improve corporate governance and improve compensation practices
 - Many of these proposals would confer greater influence on shareholders
 - The SEC has also launched several initiatives to maintain its presence in these areas

2009 – A Governance and Compensation Timeline

- ▶ January 30, 2009 – S. 360 – The Cap Executive Officer Pay Act of 2009 (McCaskill) introduced
- ▶ February 17, 2009 – the American Recovery and Reinvestment Act of 2009 is signed into law
- ▶ May 19, 2009 – S. 1074 – The Shareholder Bill of Rights Act of 2009 (Schumer) introduced
- ▶ May 20, 2009 – the SEC proposes “proxy access” rule
 - Would give large shareholders the ability to nominate their own director candidates in company’s proxy materials
- ▶ June 10, 2009 – Treasury Secretary Geithner issues series of executive compensation principles to guide future executive compensation design
 - Also issues Interim Final Rule providing guidance on the executive compensation standards of the Emergency Economic Stabilization Act of 2008, as amended by ARRA

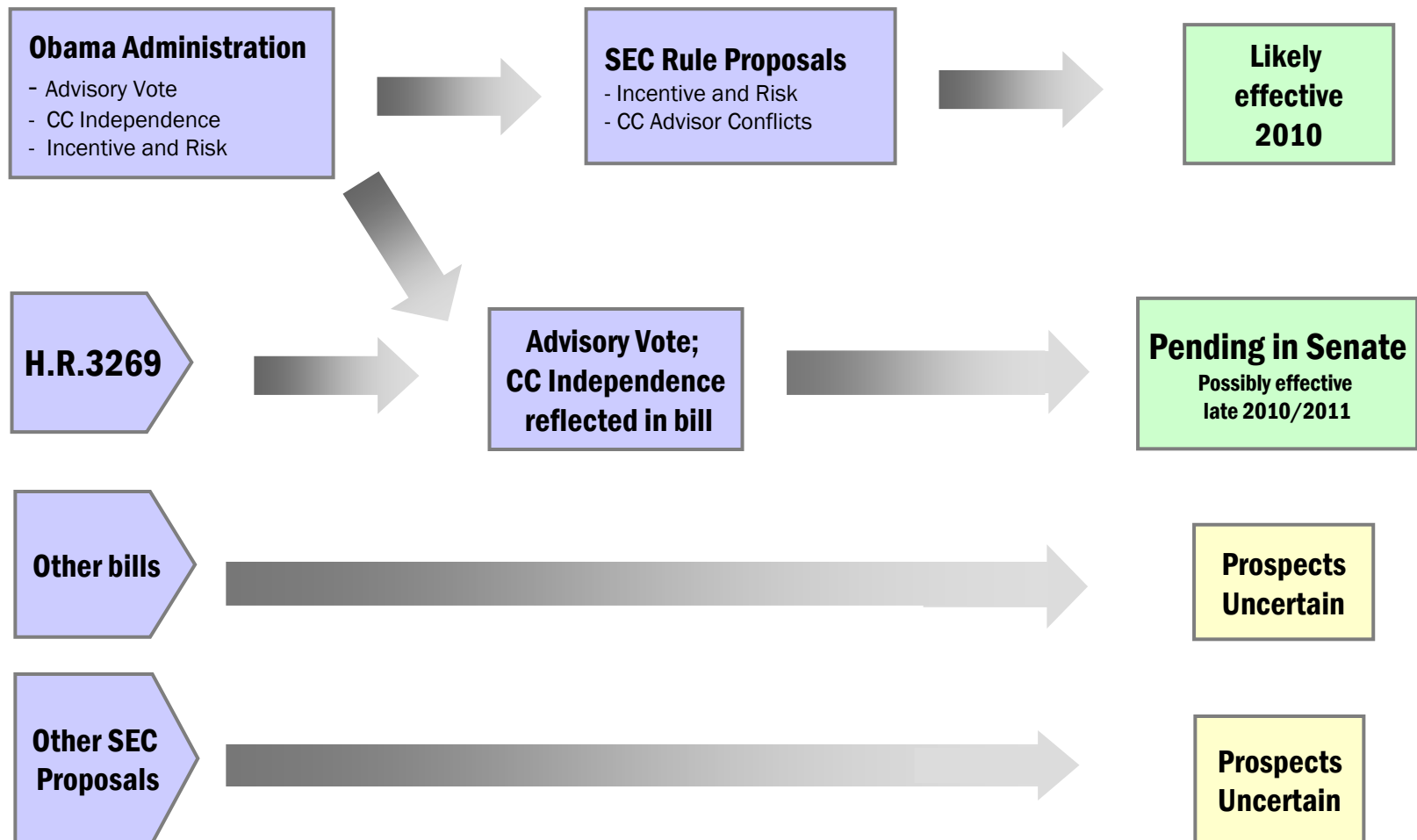
2009 – A Governance and Compensation Timeline

- ▶ June 19, 2009 – H.R. 2861 – The Shareholder Empowerment Act of 2009 (Peters) introduced
- ▶ July 1, 2009 – the SEC proposes changes to its proxy disclosure rules and approves an amendment to NYSE Rule 452
 - Rule change prohibits brokers from voting uninstructed shares in uncontested director elections
- ▶ July 16, 2009 – Treasury Secretary Geithner issues legislative proposals for advisory vote on executive compensation and compensation committee independence
 - Proposals are incorporated into H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009 (Frank)
- ▶ July 31, 2009 – H.R. 3269 approved by the House of Representatives
 - Presently, pending consideration in the Senate

2009 – A Governance and Compensation Timeline

- ▶ October 3, 2009 – SEC confirms that “proxy access” will be considered in 2010
- ▶ October 15, 2009 – SEC proposes changes to “e-proxy” rules
 - Impetus may have been amendment to Rule 452
- ▶ October __, 2009 – Special Master issues decisions on compensation for financial institutions receiving exceptional assistance
- ▶ November __, 2009 – SEC adopts changes to proxy disclosure rules
- ▶ _____, 2009 – Congress approves corporate governance/executive compensation reform legislation
- ▶ _____, 2009 – Treasury Department adopts Final Rule on the executive compensation standards of EESA and ARRA

Who's Doing What to Whom (and When)



Obama Administration Executive Compensation Principles

- ▶ On June 10, 2009, Treasury Secretary Geithner identified five principles to guide the development of reforms to better align compensation practices – particularly in the financial sector – with sound risk management and long-term growth
- ▶ **Implications:**
 - While applicable to all companies, the topics appear oriented towards problems in financial sector
 - Clearly, the Administration had compensation practices of the financial sector in mind when formulating principles
 - Several principles – establishing pay-for-performance link, structuring program for long-term value creation, validating need for post-employment compensation packages – merely confirm pre-existing “sound compensation practices
 - Only truly “new” principle involves conducting periodic (annual) risk assessment to ensure that compensation arrangements do not promote “excessive or unnecessary” risks
- ▶ It’s clear that the Obama Administration does not intend to cap pay or otherwise dictate precisely how companies should set compensation

Obama Administration Executive Compensation Principles

- ▶ The five principles:
 - 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
 - Companies should reexamine whether “golden parachutes” and supplemental retirement packages align the interests of executives and shareholders
 - Companies should promote transparency and accountability in the process of setting compensation
 - Many 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 and better information explaining a company’s compensation packages
 - Existing disclosures typically fail to make clear in a single place the total “walk-away” amount due an executive, including severance, pensions, and deferred compensation

Obama Administration Executive Compensation Initiatives

- ▶ The Obama Administration indicated that it intends to work with Congress to pass legislation in two specific areas:
 - An advisory vote on executive compensation
 - Giving the SEC the power to ensure that compensation committees are more independent (using standards similar to those in place for audit committees as adopted under the Sarbanes-Oxley Act)
- ▶ These proposals have been incorporated into H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009
- ▶ The only other major compensation-oriented regulatory initiative that has been undertaken is the SEC's proposal to require additional disclosure about compensation and risk management



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Advisory Vote on Executive Compensation (“Say on Pay”)

- ▶ Shareholders should be able to vote on company’s executive compensation program
 - Vote is “advisory” only (that is, voting results are non-binding on company)
 - Vote is on “executive compensation” (an opaque term) based on company’s executive compensation disclosure as presented in proxy statement

- ▶ In 2009, Say on Pay proceeded simultaneously on three fronts:
 - Shareholders are seeking – on a company-by-company basis – the adoption of an annual vote requirement
 - Some companies have unilaterally (or as the result of a favorable shareholder vote) elected to begin conducting an annual advisory vote on their executive compensation programs
 - The Obama Administration and Congress are working on legislation that would require all public companies to conduct an annual advisory vote on executive compensation

Advisory Vote on Executive Compensation (“Say on Pay”)

- ▶ Shareholder proposals requesting company to hold annual advisory vote on executive compensation increased for fourth consecutive year
 - Initially, seven proposals in 2006, receiving average support of 40.1% of shareholders
 - 51 proposals in 2007, receiving average support of 42.2% of shareholders (9 passed)
 - 79 proposals in 2008; support still averaged 41.4%, 11 proposals were approved by shareholders
 - Over 100 proposals in 2009 (70 proceeded to vote); receiving average support of ~45%, over 20 have passed so far (see Exhibit B)
 - These proposals are themselves non-binding, so companies not required to comply
 - However, a few companies have agreed to hold an annual advisory vote in response to the passage of a shareholder resolution
 - Other companies are under pressure to implement an annual advisory vote

Advisory Vote on Executive Compensation (“Say on Pay”)

- ▶ Number of companies actually conducting an advisory vote on executive compensation increased dramatically in 2009
 - ~8 companies held votes in 2008 (AFLAC and RiskMetrics most prominent); all passed by wide margins
 - ~17 companies have held votes (so far) in 2009; all have passed with votes ranging from mid-50% (Jackson Hewitt) to high 80% - low 90%
 - American Recovery and Reinvestment Act of 2009 required all TARP participants (approximately 275 companies) to conduct an advisory vote on executive compensation in 2009
 - So far, all of these votes have been approved by wide margins ranging from 51% to 100%

Advisory Vote on Executive Compensation (“Say on Pay”)

- ▶ A legislatively-mandated advisory vote on executive compensation is likely to be approved by Congress and signed into law in the future
- ▶ The Obama Administration’s proposal is included in H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009
 - Includes two advisory vote requirements:
 - Annual shareholder advisory vote on executive compensation, and
 - Shareholder advisory vote on “golden parachute” arrangements in connection with mergers and other corporate transactions (if not previously subject to a shareholder vote)
- ▶ On July 31, 2009, the House of Representatives approved H.R. 3269
 - Presently awaiting consideration in the Senate

Advisory Vote on Executive Compensation (“Say on Pay”)

- ▶ As proposed, vote requirement won’t take effect until mid – to late 2010 or 2011 proxy season – or later
- ▶ Proxy advisory firms have begun developing standards that will be applied to evaluate executive compensation disclosures for purposes of formulating recommendations on advisory votes

Advisory Vote on Executive Compensation (“Say on Pay”)

► Implications:

- An advisory vote on executive compensation will compel most companies to reevaluate their current approach to the executive compensation disclosure in their proxy statements
- Some companies may need to mount a proactive campaign to ensure a favorable vote result
- Influence of the major proxy advisory firms will increase

Advisory Vote on Executive Compensation (“Say on Pay”)

- ▶ What Compensation Committees should be doing:
 - Conduct analysis of shareholder base
 - Identify any features of current executive compensation program that are objectionable to major proxy advisory firms
 - Review 2009 executive compensation disclosure (particularly the Compensation Discussion and Analysis)
 - Monitor potential effective date
 - Monitor responses of key institutional shareholders and peer companies to enactment of legislation



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Compensation Committee Independence and Operation

- ▶ The Obama Administration has publicly stated its support for greater autonomy for board compensation committees
- ▶ H.R 3269 contains increased independence standards for compensation committee members, as well as independence standards for compensation consultants and other similar advisors
 - Rules to be implemented by national securities exchanges, so will only apply to listed companies
 - To be “independent,” compensation committee members may not accept any consulting, advisory, or other compensatory fee from company (other than for serving as director)
 - Committees would be expected to use consultants and other similar advisors that meet “independence” standards set by SEC
 - Companies would be required to disclose whether committee obtained advice of independent compensation consultant

Compensation Committee Independence and Operation

- ▶ SEC has proposed enhanced disclosure involving compensation committees
- ▶ Proposed requirements:
 - Disclosure triggered where compensation consultant (or affiliate) that assists company or board of directors in determining or recommending executive or director compensation *also provided additional (non-executive compensation-related) services to company*
 - Disclosure would include:
 - Nature and extent of additional services,
 - Aggregate fees for compensation-related services, and
 - Aggregate fees for non-compensation-related services
 - Disclosure would also include:
 - Whether decision to engage the compensation consultant (or its affiliate) to perform the other (non-compensation-related) services was made, subject to screening, or recommended, by management
 - Whether the board of directors or the board compensation committee approved the provision of these services

Compensation Committee Independence and Operation

- ▶ What Compensation Committees should be doing:
 - Verify compliance with current listing standards' director "independence" requirements
 - Determine whether compensation consultant (or an affiliate) performs non-compensation-related services for company (or any of its affiliates)
 - Monitor SEC's development of "independence" standards for compensation consultant and other similar advisors
 - Monitor disclosures of peer companies on use of compensation consultants
 - If other advisors (for example, legal counsel) used by compensation committee during year, determine whether relationship will be ongoing

Expanded Disclosure about Compensation and Risk

- ▶ SEC has proposed expanding the Compensation Discussion and Analysis to require discussion of company's programs for compensating its employees (including non-executive officers) as they relate to risk management practices and risk-taking incentives, *if these risks may have material impact on company*
 - SEC believes that the disclosure of a company's overall compensation policies and practices can help investors identify whether the company has established a system of incentives that can lead to excessive or inappropriate risk-taking

Expanded Disclosure about Compensation and Risk

- ▶ Whether disclosure will be required will depend on each company's specific situation
- ▶ As explained by SEC, the following types of compensation policies *may* necessitate disclosure:
 - Policies at a business unit that carries a significant portion of the company's risk profile
 - Policies at a business unit with compensation structured significantly differently than other units within the company
 - Policies at a business unit that is significantly more profitable than other units within the company
 - Policies at a business unit where compensation expense is a significant percentage of the unit's revenues
 - Policies that vary significantly from the overall risk and reward structure of the company (for example, when bonuses are awarded upon accomplishment of a task, while the income and risk to the organization from the task extend over a significantly longer period of time)

Expanded Disclosure about Compensation and Risk

- ▶ Required disclosure will be “principles-based,” with the following issues that *may* need to be addressed:
 - The general design philosophy of the company’s compensation policies for employees whose behavior would be most impacted by the incentives established by the policies, as such policies relate to or affect risk taking by employees on behalf of the company, and the manner of its implementation;
 - The company’s risk assessment or incentive considerations, if any, in structuring compensation policies or in awarding and paying compensation;
 - How the company’s compensation policies relate to the realization of risks resulting from the actions of employees in both the short-term and the long-term, such as through policies requiring clawbacks or imposing holding periods;
 - The company’s policies regarding adjustments to its compensation policies to address changes in its risk profile;
 - Material adjustments the company has made to its compensation policies or practices as a result of changes in risk profile; and
 - The extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met with respect to incentivizing its employees.

Expanded Disclosure about Compensation and Risk

► Implications:

- Companies will need to evaluate both executive compensation program *and* overall compensation program to determine whether any disclosure is required/advisable
- Evaluation will largely center on performance-based incentive compensation plans and arrangements
- Companies with conventional equity-based long-term incentive compensation programs likely to focus on stock price risks
 - Whether compensation will create unreasonable risk of manipulation of earnings
 - Whether compensation will encourage option “backdating” or other option pricing abuses
 - Whether company has appropriate “mitigation” features (e.g., stock ownership/retention requirements, clawbacks, etc.) and controls and procedures in place to eliminate and/or warn of potential risks
- Ultimately, purpose of requirement is to assure shareholders that company is effectively monitoring compensation programs for potential problems that may adversely affect business

Expanded Disclosure about Compensation and Risk

- ▶ What Compensation Committees should be doing:
 - Identify the components of the company's executive compensation program that create risk to the organization
 - Determine whether any components of the company's overall compensation program present potential risk issues
 - Determine appropriate body within company to evaluate compensation-related risks and schedule meeting(s) for end of the year
 - Monitor SEC's development of final rules on required risk disclosure
 - Conduct risk assessment – while the form of the assessment will ultimately depend on the final requirements of the SEC rule, potential elements of assessment will include:
 - Determine how to address topic in Compensation Discussion and Analysis

Additional SEC Disclosure Proposals

- ▶ SEC has proposed several changes to its executive compensation disclosure rules
 - These changes expected to be in place in time for 2010 proxy season
- ▶ **Proposal One** - Revises Summary Compensation Table (and Director Compensation Table) to require disclosure of the aggregate grant date fair value of stock awards and stock options (computed under SFAS 123(R))
 - Reverses current SEC requirement that equity awards be reported in SCT (and DCT) on basis of dollar amount of compensation expense recognized for financial reporting purposes during the covered fiscal year
 - Current rule is difficult for companies to apply and explain because of intricacies of SFAS 123(R) (for example, compensation cost of stock options and other equity awards to retirement-eligible employees must be fully reported in year of grant, rather than over award vesting schedule)
 - Current rule makes disclosure of stock options and other equity awards (as well as total compensation amounts) difficult for investors to understand and compare

Additional SEC Disclosure Proposals

- ▶ Proposal Two - Expand disclosure of director and director-nominee qualifications
 - Must describe each individual's specific experience, qualifications, attributes, or skills that qualify him or her to serve as a director at the time that the disclosure is made, and as a member of any committee that the individual serves on or is chosen to serve on (if known), in light of the company's business and structure; and
 - If material, the disclosure should cover more than the past five years, and include information about the individual's risk assessment skills, particular areas of expertise, or other relevant qualifications (such as past experience) as well as an explanation as to why this individual's service as a director would benefit the company
 - Would be required to expand disclosure of any directorships held by each director (and director-nominee) at public companies at any time during the past five years
 - Would be required to disclose any material legal proceedings in which a director (or director-nominee) was involved during the prior 10, rather than just five, years

Additional SEC Disclosure Proposals

- ▶ Proposal Three – Would require disclosure of company's leadership structure
 - Must disclose whether the same person serves as both CEO and Chairman of the board of directors; or two individuals serve in those positions
 - If a single person serves as both CEO and Chairman of the board, the company must disclose whether it has a lead independent director and describe the specific role that he or she plays in the leadership of the company
 - Also, the company must justify its leadership structure; specifically, explaining why it believes that its preferred structure is appropriate given its specific characteristics or circumstances

Additional SEC Disclosure Proposals

- ▶ **Proposal Four** – Would require disclosure of board of directors' role in company's risk management (including, but not limited to, credit risk, liquidity risk and operational risk matters) and the effect that this involvement has on the company's leadership structure.
 - This disclosure would be expected to address the specific processes and procedures that the board uses to monitor and manage the company's risk profile

- ▶ **Proposal Five** – Would accelerate disclosure of voting results in current report on Form 8-K, rather than after end of quarter in Form 10-Q

Increasing Director Accountability

- ▶ Many investors believe that the most effective way to oversee executive compensation practices and decisions is through greater director accountability
 - The most immediate way to hold directors accountable for their decisions is through their election (or re-election) to the Board of Directors

- ▶ In 2009, there have been three significant developments which are likely to expand director accountability
 - Elimination of broker voting of uninstructed shares held in “street name” in uncontested director elections
 - SEC is considering change to proxy rules that would permit large shareholders to nominate their own director candidates using the company’s proxy materials (“proxy access”)
 - Some of the legislative proposals introduced in Congress would, among other things, require all companies to adopt a majority voting standard for the election of directors

Director Accountability - Broker Voting of Uninstructed Shares

- ▶ SEC has approved an amendment to NYSE Rule 452 that permitted brokers holding customer shares in “street name” to vote the shares themselves in uncontested director elections if customer does not specify how shares are to be voted
- ▶ Effective for shareholder meetings in 2010, brokers will not be permitted to vote “uninstructed shares” in uncontested director elections
- ▶ Implications:
 - Companies with large retail shareholder bases may want to reconsider whether to use SEC’s “notice and access” model for electronic delivery of proxy materials (this approach has resulted in noticeably low shareholder turnout)
 - Establishing a quorum for annual meeting of shareholders will be more challenging unless have a “routine matter” (such as ratification of auditors) on ballot, which will enable brokers to vote uninstructed shares and, consequently, be counted for quorum purposes
 - Companies with a majority voting standard for the election of directors will find it more difficult to ensure election of management slate
 - Influence of proxy advisory firms and activist shareholders will increase, as institutional investor votes will have greater impact on outcome
 - “Just Vote No” campaigns will have greater (albeit symbolic) impact

Director Accountability – Access to Corporate Proxy Materials

- ▶ SEC has proposed amendments to its proxy rules that would permit certain shareholders (or shareholder groups) at public companies to include their own director nominees in company proxy materials
 - Right to nominate directors depends on satisfying minimum ownership requirements for at least one year prior to notification of intent to nominate director
 - Large accelerated filers (market float of at least \$700 million) – minimum ownership of 1%
 - Accelerated filers (market float of at least \$75 million) – minimum ownership of 3%
 - Other companies (market float of less than \$75 million) – minimum ownership of 5%
 - Nominee must satisfy “independence” standards of applicable national securities exchange and nomination cannot violate applicable law
 - Eligible shareholders may nominate greater of one individual or 25% of board seats up for election
 - Also would have to disclose significant information about director-nominee and nominating shareholder



QUESTIONS

Summary of Legislative Proposals Introduced in Congress in 2009

- ▶ S. 1074 – Shareholder Bill of Rights Act of 2009
 - Introduced by Senator Schumer
 - Provisions include:
 - Say on Pay
 - Director elections – e.g., majority voting for directors in uncontested elections, proxy access, annual election of directors, independent board chair
- ▶ H.R. 2861 – Shareholder Empowerment Act of 2009
 - Introduced by Representative Peters
 - Similar to Schumer Bill
- ▶ S. 1006 – Excessive Pay Shareholder Approval Act of 2009
 - Introduced by Senator Durbin
 - Bill would require a supermajority (for example, 60%) of shareholders of publicly-traded companies to approve the compensation structures of any employee who receives in excess of 100 times the average compensation of all company employees
- ▶ S. 1007 – Excessive Pay Capped Deduction Act of 2009
 - Introduced by Senator Durbin
 - Bill would limit the normal tax deduction for compensation to executives to 100 times the average compensation of all company employees

Summary of Legislative Proposals Introduced in Congress in 2009

- ▶ S. 1491 – Ending Excessive Corporate Deductions for Stock Options Act
 - Introduced by Senators Levin and McCain
 - Limits the tax deduction for stock options to the amount treated as an expense for accounting purposes
 - Requires tax deduction for stock options to be taken in the same period that the accounting expense is recognized
 - Provides that stock options will not qualify as “performance-based compensation” for purposes of tax code section 162(m) so that the tax deduction for stock options will be included in the \$1 million compensation deduction limit

- ▶ S. 360 – Cap Executive Officer Pay Act of 2009
 - Introduced by Senator McCaskill
 - Limits the annual amount of compensation paid to officers, directors, executives and employees of financial institutions and other entities that receive or have in the past received assistance under TARP to the amount paid to the President of the United States (approximately \$400,000)