

August 18, 2009

## **House Passes the Corporate and Financial Institution Compensation Fairness Act of 2009 (H.R. 3269)**

### **Update on Other Pending Executive Compensation Legislation**

With Congress in adjournment until September, it is timely to review the status of pending legislation that would affect executive compensation practices. In addition to the executive compensation legislation passed in February that affects financial institutions receiving TARP financial assistance,<sup>1</sup> many other bills have been introduced in this Congress that, if passed, will significantly change the executive compensation landscape. The House's passage of H.R. 3269 on July 31 reinforces the commonly held view that additional executive compensation legislation is likely before the end of 2009.

#### **H.R. 3269-The Corporate and Financial Institution Compensation Fairness Act of 2009**

We have previously reported on this legislation, which Congressman Frank and others introduced July 21.<sup>2</sup> The original terms of H.R. 3269 generally followed the legislative proposals of the Obama Administration.

Following consideration by the House Financial Services Committee, the House approved an amended version of H.R. 3269 on July 31 on a party-line vote.<sup>3</sup> The bill now proceeds to the Senate for consideration. The bill enacted by the House contains the following key features:

#### **Say on Pay**

- Shareholders must be provided with an annual, non-binding vote on executive compensation matters as disclosed in the proxy statement, including the compensation committee report, the CD&A, and the compensation tables.
- Unless previously approved, in the event of a change-in-control transaction (i.e., acquisition, merger or asset sale), shareholders must be provided with a non-binding vote on named executive officer compensation related to the transaction (also known as "golden parachute" compensation); companies would be required to disclose agreements providing for such compensation in the transaction proxy statement in "clear and simple form," as well as the total compensation that may become payable under the agreements.
- Votes would be required for any proxy statement for shareholder meetings held six months or more after the SEC issues final rules. Final rules are required within six

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<sup>1</sup> See our letter of February 18, 2009, "Congress Expands Restrictions on Executive Compensation for Financial Institutions under Troubled Asset Relief Program," [http://www.fwcook.com/alert\\_letters/02-18-09\\_Congress-Expands-Restrictions-on-Executive-Compensation.pdf](http://www.fwcook.com/alert_letters/02-18-09_Congress-Expands-Restrictions-on-Executive-Compensation.pdf)

<sup>2</sup> See our letter of July 23, 2009, "Treasury Proposes Legislation to Congress for Say-on-Pay and Compensation Committee Independence," [http://www.fwcook.com/alert\\_letters/07-23-09\\_TreasuryProposesLegislationtoCongressforSayonPay.pdf](http://www.fwcook.com/alert_letters/07-23-09_TreasuryProposesLegislationtoCongressforSayonPay.pdf).

<sup>3</sup> The vote totals were Democrats—235 yes, 16 no, 4 not voting; Republicans—2 yes, 169 no, 7 not voting.

months of enactment, and the SEC has authority to exempt issuers “where appropriate,” including taking into account the impact on smaller companies. Commentators have noted that these timing rules likely mean the new rules will not apply to proxy statements in the first half of 2010.

- Institutional investment managers required to file Form 13F reports (generally, managers with investment discretion over at least \$100 million of exchange-traded equity securities) will be required to disclose how they voted.

#### Compensation Committee Independence

Effective no later than nine months after enactment, the SEC must issue rules prohibiting national securities exchanges and national securities associations from listing the equity securities of an issuer unless the following five requirements are met:

- Each member of the compensation committee must be independent, which requires that the member not receive, other than as a board or committee member, any “compensatory fee” from the issuer. The SEC is granted authority to exempt relationships “where appropriate in view of the purposes of this section.”
- Any compensation consultant or “other similar adviser” to the compensation committee must meet standards of independence to be defined by the SEC.
- The compensation committee must have the authority to retain an independent compensation consultant and be directly responsible for the appointment, compensation, and oversight of the consultant’s work. Beginning one year after enactment, proxies must disclose whether an independent compensation consultant was retained.
- The compensation committee must also have the authority to retain independent counsel and other advisers meeting the SEC’s independence standards.
- Each issuer must provide the compensation committee with appropriate funding (as determined by the committee) to pay these independent advisers.

The SEC has power to issue “appropriate” exemptions from these rules and is directed to take into account the impact of the rules on smaller reporting issuers as part of this process.

#### Additional Reporting and Regulation of Financial Institution Compensation Structures

The most controversial provision of H.R. 3269 is the regulation of the compensation structures of financial institutions with assets of \$1 billion or more (this section was not part of the Obama Administration bill that H.R. 3269 was based on). A “financial institution” is not limited to recipients of TARP financial assistance and is broadly defined to include any depository institution, broker-dealer, credit union, investment adviser, Fannie Mae and Freddie Mac, or any other financial institution determined to be includible by the regulatory agencies listed in the bill. This section has the following key features:

- Within nine months of enactment, regulations must be issued by the appropriate regulatory agencies requiring each covered financial institution to report to its regulatory agency details of all its incentive compensation arrangements, in sufficient detail for the regulatory agency 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 other criteria appropriate to reduce unreasonable incentives for employees to take undue risks that could threaten the firm or have serious effects on economic conditions or financial stability.
- Within nine months of enactment, the regulatory agencies will issue regulations prohibiting any incentive compensation arrangements or features determined to

- encourage inappropriate risks that could threaten the safety and soundness of the covered companies or have serious adverse effects on economic conditions or financial stability.
- The bill provides that regulations under this section cannot require recovery of any incentive compensation under arrangements in effect on the date of enactment so long as the arrangements are for a period of not more than 24 months.
  - The Comptroller General is directed to issue a report within one year examining whether the compensation structures in existence from 2000 to 2008 led to excessive risk-taking.

### **Other Pending Legislation**

Reflecting the belief that inappropriate executive compensation and corporate governance practices played a significant role in the economic crisis and financial market deterioration of the last 12 months, a wave of proposed legislation has been introduced in the current session of Congress that would affect executive compensation.<sup>4</sup>

Attached are two appendices that summarize the key legislation currently pending.<sup>5</sup>

- Appendix A summarizes key provisions in pending bills that affect executive compensation.<sup>6</sup> As noted on the chart, all of these the bills are currently at the committee level and none have been voted on by the House or the Senate. Because one of these bills (S. 1491) affects executive compensation by significantly changing the tax rules applicable to stock options, it is discussed below.
- Appendix B summarizes pending legislation relating to TARP recipients. Two bills, H.R. 1664 and H.R. 1586, have passed the House, but so far have not been the subject of any Senate action. H.R. 1664 contains general rules regarding executive compensation. H.R. 1586 was passed in reaction to the disclosure that AIG was paying hundreds of millions of dollars in bonuses to its executives. It provides that, in the case of executives at TARP companies receiving more than \$5 billion in financial assistance, bonuses will generally be taxed at a 90% rate to the extent adjusted gross income exceeds \$250,000.

### **Ending Excessive Corporate Deductions for Stock Options Act (S. 1491)**

On July 22 Senators Levin and McCain introduced S. 1491, the “Ending Excessive Corporate Deductions for Stock Options Act, which has been referred to the Senate Finance Committee. While Senator Levin has introduced variations of this bill starting in 1997, the bill’s prospects for passage are higher this year because of (1) the current Congressional concern over executive compensation (in particular, the view that some forms of executive compensation, including options, may have encouraged executives to take excessive risks) and (2) the need for revenue in light of current and expected budget deficits.

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<sup>4</sup> For example, see our letter of May 22, 2009, “Shareholder Bill of Rights Act of 2009 Introduced in Senate,” [http://www.fwcook.com/alert\\_letters/05-22-09-Shareholder-Bill-of-Rights-Act.pdf](http://www.fwcook.com/alert_letters/05-22-09-Shareholder-Bill-of-Rights-Act.pdf).

<sup>5</sup> In addition, the Obama Administration has issued draft legislation (the Investor Protection Act of 2009) that would authorize the SEC to regulate compensation practices of financial intermediaries, including brokers, dealers, and investment advisers. This legislation has not yet been introduced in Congress.

<sup>6</sup> H.R. 3351, the “Proxy Voting Transparency Act of 2009” (introduced by Rep. Kilroy on July 27) is omitted from the chart. Its requirements regarding shareholder approval of executive compensation and golden parachute arrangements are substantially identical to the rules in H.R. 3269.

The Act would amend the Internal Revenue Code to provide that the tax deduction for stock options equals the amount treated as an expense for accounting purposes and that the deduction will be allowed for the same period that the accounting expense is recognized. In addition, the bill provides that deductions for stock options will not qualify for the exception for performance-based compensation under Internal Revenue Code section 162(m). As a result, the deduction will be counted against the annual \$1 million limit on deductible compensation that applies to the company's CEO and the three other most highly compensated executive officers at the end of the year (other than the CFO).

If passed in its current form, the legislation could significantly reduce, if not eliminate, the use of stock options while neither significantly changing the structure of executive compensation nor raising significant revenue. Our reasons for these conclusions are the following:

- The bill only applies to stock options. In lieu of stock options, issuers could instead grant stock-settled stock appreciation rights (SARs), which would have the same financial impact on executives without the adverse deduction and section 162(m) consequences.
- If the bill is amended to include SARs, issuers could shift the delivery of equity compensation to a combination of restricted stock, restricted stock units, and performance shares. Depending on how they are structured, these equity compensation vehicles can replicate many of the features of stock options, particularly if the value at vesting is tied to stock price appreciation.
- Even if the vesting of stock options is performance-based, the options will not meet the performance-based exception under section 162(m).

It should also be noted that the bill's language creates significant confusion with regard to what happens if options are never exercised (e.g., they expire underwater) and how the effective date rules apply. Senator Levin's Floor Statement states that "if a company incurred a stock option expense, it would always be able to claim a tax deduction for that expense." The actual legislation states, however, that it only applies to options exercised after enactment, indicating that the accounting expense cannot be deducted in the case of underwater options (since they will never be exercised). There are other ambiguities with regard to how the effective date provisions of the bill, so it will important to see how this feature of the bill is clarified.<sup>7</sup>

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This letter is intended to alert compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice. General questions about the subjects in this letter may be directed to David Gordon at 310-734-0111 ([degordon@fwcook.com](mailto:degordon@fwcook.com)) or Richard Alpern at 212-299-3599 ([ralpern@fwcook.com](mailto:ralpern@fwcook.com)). Copies of this letter and other published materials are available on our website at [www.fwcook.com](http://www.fwcook.com).

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<sup>7</sup> For example, if the accounting expense of options can be immediately deducted for tax purposes, regardless of whether an option is eventually exercised, some issuers may decide they prefer options over SARs because options provide a certain deduction today while an SAR will only result in a better tax result if it is exercised in the future at a spread greater than the accounting charge.

**APPENDIX A**  
**KEY PROVISIONS IN BILLS AFFECTING EXECUTIVE COMPENSATION**

<i>Item</i>	<i>S. 1006 &amp; S. 1007- Excessive Pay Shareholder Approval Act &amp; Excessive Pay Capped Deduction Act</i>  <i>May 7 Durbin Bill (1)</i>	<i>S. 1074- Shareholder Bill of Rights Act of 2009</i>  <i>May 19 Schumer Bill (2)</i>	<i>H.R. 2861- Shareholder Empowerment Act of 2009</i>  <i>June 12 Peters Bill (3)</i>	<i>H.R. 3126-Consumer Financial Protection Agency Act of 2009</i>  <i>July 8 Frank Bill (4)</i>	<i>H.R. 3272- Corporate Governance Reform Act of 2009</i>  <i>July 21 Ellison Bill (5)</i>	<i>S. 1491-Ending Excessive Corporate Deductions for Stock Options Act</i>  <i>July 22 Levin/ McCain Bill (6)</i>
Majority voting for directors		Required in uncontested elections				
Access to proxy to nominate directors		Yes (1% shareholders for 2 years)				
Miscellaneous rules regarding directors		Annual election of directors required	No discretionary broker voting in uncontested elections		SEC to study certification standards for directors	
Independent Board Chair		Required (former executive officer not permitted)	Required (5-year wait if former employee)		Required	
Compensation Committee					Members must be independent	
Risk management committee and risk management officer		Independent committee required			Independent committee & chief risk officer required	
Shareholder approval of executive compensation	Unless 60% of shareholders approve (based on required disclosure of employee compensation), no employee can receive compensation exceeding 100 times average compensation of all employees (S. 1006)	Annual nonbinding vote required; nonbinding vote on golden parachutes required in connection with transaction	Annual nonbinding vote required		Annual nonbinding vote required	

<i>Item</i>	<i>S. 1006 &amp; S. 1007</i>	<i>S. 1074</i>	<i>H.R. 2861</i>	<i>H.R. 3126</i>	<i>H.R. 3272</i>	<i>S. 1491</i>
Compensation advisers			Must be independent			
Miscellaneous compensation rules and executive compensation standards and regulation (including tax rules)	No deduction allowed for employee compensation exceeding 100 times average compensation of all employees (S. 1007)		Required recoupment of unearned bonuses (e.g., paid due to fraud or financial results requiring restatement; no severance pay to executive officers if terminated for poor performance; increased CDA disclosure of performance targets)	New federal agency can “establish duties regarding compensation practices” applicable to persons providing consumer financial products or services; rules cannot provide limits on the total amount of compensation		Tax deduction for stock options limited to accounting expense; options not treated as performance based-compensation under 162(m)

- (1) S. 1006 & S. 1007—Excessive Pay Shareholder Approval Act & Excessive Pay Capped Deduction Act (Sen. Durbin); both bills introduced 5/7/09 and referred to Banking, Housing, and Urban Affairs Comm.; Excessive Pay Capped Deduction Act discharged and referred to Finance Comm. 6/2/09
- (2) S. 1074—Shareholder Bill of Rights Act of 2009 (Sen. Schumer and other); referred to Banking, Housing, and Urban Affairs Comm. on 5/19/09
- (3) H.R. 2861—Shareholder Empowerment Act of 2009 (Rep. Peters and others); referred to Financial Services Comm. on 6/12/09
- (4) H.R. 3126—Consumer Financial Protection Agency Act of 2009 (Rep. Frank and others); referred to Financial Services Comm. on 7/8/09; bill is based on legislative language proposed by Obama Administration
- (5) H.R. 3272—Corporate Governance Reform Act of 2009 (Rep. Ellison); referred to Financial Services Comm. on 7/21/09
- (6) S. 1491—Ending Excessive Corporate Deductions for Stock Options Act (Sens. Levin and McCain); referred to Finance Comm. on 7/22/09

## APPENDIX B—PENDING LEGISLATION AFFECTING TARP COMPANIES

<b><i>LEGISLATION NOT RELATED TO AIG BONUSES</i></b>	<b><i>KEY PROVISIONS</i></b>
<b><i>H.R. 1664</i></b> (Rep. Grayson and others) <b><i>Status</i></b> -passed by House 4/1/09; placed on Senate Legislative Calendar 4/23/09	Subject to certain exceptions, prohibits any compensation payment by recipients of direct capital investments under TARP other than “a longevity bonus or a payment in the form of restricted stock” if the compensation (1) is unreasonable or excessive, based on standards established by the Secretary of the Treasury, or (2) that includes any “bonus or other supplemental payment” not based on performance measures set forth in standards established by the Secretary.
<b><i>S. 431</i></b> -Economic Recovery Adjustment Act of 2009 (Sen. Whitehouse and others) <b><i>Status</i></b> -referred to Banking, Housing & Affairs Comm. 2/12/09	Establishes within Department of Justice the Office of Taxpayer Advocate to conduct audits and oversight of executive compensation arrangements of TARP recipients. In the case of entities that would have become insolvent but for TARP assistance, the Advocate is directed to negotiate reductions in executive compensation in an amount “not less than the estimated value of the compensation obligations” that the recipient would have faced in bankruptcy absent the TARP funds. Absent a negotiated settlement, another body (the Temporary Economic Recovery Oversight Panel) shall issue an order imposing the appropriate reductions.
<b><i>S. 928</i></b> -TARP Accountability Act of 2009 (Sen. Pryor) <b><i>Status</i></b> -referred to Banking, Housing & Affairs Comm. 4/29/09	Imposes additional reporting requirements on TARP recipients, including information with respect to compliance with executive compensation restrictions.
<b><i>LEGISLATION RELATED TO AIG BONUSES</i></b>	<b><i>KEY PROVISIONS</i></b>
<b><i>H.R. 1586</i></b> -Passed House 3/19/09; placed on Senate Legislative Calendar 3/23/09	Applies to employees of entities receiving more than \$5 billion of financial assistance if the employee receives a “disqualified bonus payment” after 2008, which is generally defined as any payment in addition to base pay. To the extent adjusted gross income exceeds \$250,000, the disqualified bonus payment is taxed at a 90% rate. In addition to H.R. 1586, a number of similar bills were introduced in the House, but have not been acted on (H.R. 1518, 1527, 1542, 1543, 1572, 1598, and 1801).
<b><i>H.R. 1575</i></b> -End Government Reimbursement of Excessive Executive Disbursements (End GREED) Act (Rep. Conyers and others) <b><i>Status</i></b> -reported by Judiciary Committee 3/24/09	Applies to recipients of more than \$10 billion in financial assistance. Authorizes Attorney General to invalidate payments to employees after 9/1/08 if the recipient did not get “reasonably equivalent value” and the recipient would have been insolvent absent federal assistance. Attorney General is also authorized to commence an action to limit compensation whenever the compensation would exceed 10 times the average compensation paid to non-management employees.
<b><i>S. 651</i></b> -Compensation Fairness Act of 2009 (Sen. Baucus and others) <b><i>Status</i></b> -placed on Senate Calendar 3/23/09	<b><i>Excessive bonuses</i></b> – If an executive of a recipient of more than \$100 million of TARP assistance receives an “excessive bonus” the executive and the TARP recipient are each subject to an excise tax to 35% of the bonus. Generally, an excessive bonus is (1) any retention bonus or (2) other bonus over \$50,000, unless paid in stock with at least three-year vesting. <b><i>\$1 million limit on deferred compensation</i></b> - In the case of a TARP recipient, 409A will be violated if more than \$1 million is deferred for an employee in a calendar year.