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Comprehensive Executive Compensation "Reform" Bill Introduced into Senate

On April 15, 2008, Senator Hillary Clinton introduced the **Corporate Executive Compensation Accountability and Transparency Act** (S. 2866, or "Act"), which was referred to the Senate Committee on Finance. While the fate of S. 2866 is uncertain, the Act's provisions are far reaching and many expect new bills containing similar provisions to be introduced in the future as well as proposals from institutional investors, like the petition from the Treasurer of the state of Connecticut, cited below.

The Act provides for six key initiatives:

1. Amends Section 409A of the Internal Revenue Code by placing a $1 million limit on non-qualified compensation that can be deferred in a single taxable year.

2. Amends the Sarbanes-Oxley Act by extending the recoupment period for CEO and CFO bonuses, equity compensation, and stock profits received from 12 to 36 months, following the first public issuance or filing of a financial document that requires restatement.

3. Amends Section 14 of the Securities Exchange Act of 1934 by mandating an annual non-binding shareholder vote on executive compensation. The amendment would also provide shareholders a non-binding vote on new or modified compensation arrangements directly related to a reorganization of the company.

4. Requires that the Securities and Exchange Commission (SEC) establish specific disclosure rules to limit potential conflicts of interest by defining "independence" between public companies and their executive compensation consultants and prohibiting work by compensation consultants for board compensation committees that presents a conflict of interest.

5. Amends Federal civilian and defense contracting rules by increasing executive compensation disclosure requirements for companies (public or private) generally receiving more than $5 million per year from specific types of federal contracts.

6. Requires that the SEC mandate the use of the grant date present value of equity awards in lieu of the FAS 123R expense accrued during the year, which is intended to provide a clearer and more complete picture of compensation provided to named executive officers and directors.

Limitation on Annual Amounts Which May Be Deferred Under Non-qualified Deferred Compensation Arrangements

Currently, there are no limits on the amounts that can be deferred under non-qualified plans. The amendment to Section 409A of the Internal Revenue Code of 1986 would place an annual individual limit of $1 million on the aggregate amount of compensation that may be deferred under non-qualified deferred compensation plans. This provision would become effective after December 31, 2008. All forms of deferred compensation (i.e., not just elective deferrals) would be covered, which would potentially include accruals under SERPs, earnings on previously deferred amounts, and certain forms of severance pay. Any amount in excess of the limit that is not subject to substantial risk of forfeiture would be included in gross income and subjected to a 20% excise tax.

Executive Reimbursement of Compensation for Misconduct

The Sarbanes-Oxley Act of 2002 requires the CEO and CFO to reimburse the company for certain payments in the event of an accounting restatement due to the material noncompliance (as a result of "misconduct") with any financial reporting requirement. Reimbursement applies to any bonus, equity compensation, or stock sale profits received during the 12-month period following the filing of financial statements which require restatement. The proposed amendment would extend the recoupment period to 36 months.

The Act establishes related guideline definitions, as follows:

1. "Misconduct" includes specific illicit actions taken by any of the company's senior executives or officers, including the CEO and CFO, or knowledge of such actions accompanied by willful inaction to address such actions or willful concealment.
2. "Illicit Actions" include activities such as (i) backdating of stock options, (ii) accounting irregularities to conceal liabilities, losses, or any other negative financial information from shareholders and investors, (iii) accounting irregularities designed to artificially achieve profit or other financial targets, (iv) willfully circumventing reporting, due diligence, disclosure, or fiduciary requirements, and (v) any conduct that violates, or is in conflict with, the legal and fiduciary responsibilities of the senior executive or officer to the shareholders and boards of directors.

In addition, while the SEC would retain the authority to exempt any executive from clawback sanctions, it would be required to issue a public statement within 15 days, explaining all the factors pertaining to any exemption granted.

Shareholder Vote on Executive Compensation Disclosures

On April 20, 2007, Senator Barack Obama introduced the Shareholder Vote on Executive Compensation Act (S. 1181) that would require public companies to provide shareholders an annual advisory vote on the executive compensation disclosures contained in their proxy filings, as well as a non-binding vote on contingent payment arrangements in the case of proxies filed in connection with a corporate reorganization. Senator Clinton's bill contains generally equivalent requirements.

Effective for annual meetings on or after January 1, 2009, shareholders would be provided an annual non-binding vote to approve executive officer compensation as disclosed in the proxy statement (i.e., in the compensation discussion and analysis, the compensation tables, and any related material).

Shareholders would also be provided a non-binding vote on contingent payment arrangements (e.g., severance and other compensation related to the reorganization) not previously approved, as part of a proxy solicitation for the approval of a merger or other sale/disposition of the company.

Disclosure of Compensation Consultant Activities and Independence

The Act would require the SEC to establish regulations clarifying and strengthening disclosure requirements for the compensation of consultants or advisors to the compensation committee. In addition, the regulations would:

1. Prohibit any other work or service performed by a compensation consultant on behalf of the company that presents a conflict of interest or otherwise compromises the independence of the consultant.

2. Require the company to certify whether its compensation consultant is independent.

3. Clarify the standards to be used by the SEC to determine the independence of compensation consultants. The consultant would not be considered independent if (i) the consultant had a non-compensation consulting-related business or financial relationship with that company during the prior 18 months, or (ii) a previous financial or professional relationship existed with the company, the board of directors, or any senior executive officers, that would reasonably be construed as presenting a conflict of interest.

These rules are broad reaching and would appear to prohibit the board's compensation consultant from providing any additional services to the company. Multi-line firms would be required to either terminate their board compensation consulting relationships or dissolve/spin off their compensation consulting practices.

On May 12, 2008, the Treasurer of the State of Connecticut, on behalf of 21 institutional investors representing $1.4 trillion in assets, issued a petition to Chairman Cox of the SEC calling for greater disclosure in the area of compensation consultant independence. The petition articulates a belief that companies with consultants hired to work for both management and the compensation committee have, by definition, a conflict of interest that has the potential to jeopardize the consultant's integrity. It calls for independence safeguards similar to those under Senator Clinton's proposal with an additional requirement that consultants working for the compensation committee have their partnership/ownership interest disclosed in the proxy. The petition illustrates that concerns over compensation consultant independence are not exclusively a political issue, but a broader concern shared by institutional shareholders.

Requirement for Certain Federal Contractors to Disclose Executive Compensation Structures

The amendment would increase disclosure requirements on executive compensation for companies receiving generally more than $5 million per year from certain types of federal contracts. The extensive compensation disclosure requirements encompass the CEO, the CFO, the five highest paid executives, and the board of Directors, and would include "an analysis that justifies the compensation structures for [the covered individuals], including a good faith analysis and comparison of prevailing standard industry and market compensation structures with the compensation structures of such individuals." Also, within 90 days of securing covered federal contracts, the company would be required to provide a Compensation Discussion and Analysis explaining the rationale for the compensation structures for the above-defined individuals.

Increasing Transparency on Stock Options Accounting and Accurate Valuation of Executive Compensation

Currently, the Summary Compensation Table in the proxy reports the value of equity compensation for executives using the FAS 123R expense accrued during the most recently completed fiscal year (for previously awarded, but unvested stock options and stock awards).

The SEC would be required to issue new regulations designed to provide investors with a more accurate picture of the intended value of annual compensation for executives and directors by requiring disclosure of the "grant date present value" of stock option and stock awards made to the named executive officers and members of the board in the most recently completed fiscal year. Presumably these award values would replace the accounting values currently disclosed in the Summary Compensation Table (and Director Compensation Table), but this is not clear.

Conclusion

Senator Clinton's bill is a broad response to concerns over executive pay practices at publicly traded companies, and it is currently unclear whether it will be voted out of Committee. As of the date of this writing, there are no co-sponsors; however, it is realistic to expect that similar legislation will be introduced next year under a new Administration.

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General questions about the subjects in this letter may be directed to Aaron Burke or David Gordon in our Los Angeles office at (310) 277-5070 or Frederic Cook in our Tarrytown office at (914) 460-1101.