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Obama Administration Releases Executive Compensation Principles and Proposals for U.S. Public Companies

In a coordinated move, the Secretary of the Treasury, Tim Geithner, and the Chair of the SEC, Mary Schapiro, released executive compensation principles and proposals for all U.S. public companies on Wednesday.[*] These are not to be confused with Treasury regulations applicable to TARP companies, also released on Wednesday, which implement the Dodd amendments to the American Recovery and Reinvestment Act of 2009 ("ARRA"), amending the executive compensation provisions of the Emergency Economic Stabilization Act of 2008 ("EESA"). Nor are they to be confused with the Administration's expected executive compensation principles and directives governing major financial firms post-TARP, which have not yet been issued. It is expected these will be coming from the Federal Reserve.

The remainder of this letter deals with the Administration's executive compensation principles and proposals aimed at all U.S. public companies, including financial institutions.

Background – Overall Themes

The Obama Administration's executive compensation principles and proposals stem from a belief that executive compensation and board governance practices among large banks and other financial institutions contributed to the financial crisis of 2008 and ensuing global recession. Specifically, it is thought that leveraged compensation programs containing asymmetrical incentives for short-term gains and inadequate board oversight led to short-term behavior and excessive risk-taking, which in turn overwhelmed risk controls and led to substantial losses requiring massive bailout efforts to prevent systemic collapse of the financial system and the economy as a whole.

Treasury Statement

Secretary Geithner's statement lays out five broad-based principles that are expected to evolve over time with the help of industry and expert advice. They are meant to be particularly applicable to the financial sector, but extend to all companies. They are principles-based rather than prescriptive of plan design or administration. Importantly, they do not cap pay. The goal is to "develop standards that reward innovation and prudent risk-taking without creating misaligned incentives."

[*] See http://www.ustreas.gov/press/releases/tg163.htm [statement by Treasury Secretary Tim Geithner on Compensation] and http://www.sec.gov/news/press/2009/2009-133.htm [Chairman Schapiro Statement on Executive Compensation]

The five principles are:

1. First, compensation plans should properly measure and reward performance.

The goal is to have incentives for performance that leads to long-term value creation, as measured by a "wide range of internal and external metrics, not just stock price." In testimony the following day (June 11) before the House Financial Services Committee, a member of Mr. Geithner's staff expanded upon this first principle by saying, "Performance pay based solely on stock price can on the one hand, 'confuse brains for a bull-market' and in the other scenario, fail to recognize exceptional contributions by executives in difficult times. A thoughtful mix of performance metrics could include not only stock prices, but individual performance assessments, adherence to risk management and measures that account for the long-term soundness of the firm."[**]

<u>Comment</u>: We interpret this directionally to lead to a shift in longer-term incentives away from stock price growth and relative TSR as the primary measures of long-term value creation towards performance plans based on metrics that align executive incentives with sound risk management and sustainable growth. Said differently, the goal would be to create value for long-term shareholders rather than to create shareholder value.

2. Second, compensation should be structured to account for the time horizon of risks.

The Treasury advocates paying "top executives in ways that are closely aligned with the long-term value and soundness of the firm." Paying in stock that would be held for longer periods of time is advocated as one way, but not the only way, to do this. Long-term performance plans where value is lost if strong performance in one year is followed by weak performance in another is mentioned as another approach. The idea is to match compensation outcomes with risk outcomes, not just for top executives but for other key employees as well.

<u>Comment:</u> This principle may be particularly aimed at financial firms with "tail risks," but is equally applicable to any company where an over-emphasis on short-term financial performance can undermine the long-term health of the enterprise.

3. Third, compensation practices should be aligned with sound risk management.

The premise of this principle is that imprudent risk-taking was often not checked by risk controls because "risk managers too often lacked the stature or the authority necessary to impose a check on these activities." Treasury calls upon compensation committees to conduct and publish pay-risk assessments and to "provide risk managers with the appropriate tools and authority to increase their effectiveness."

<u>Comment:</u> We expect annual pay-risk assessments, a requirement for TARP firms, to evolve as a best and standard practice for other firms as well.

[**] See http://www.treas.gov/press/releases/tg166.htm [Gene Sperling Opening Statement before the House of Representatives Committee on Financial Services]

4. Fourth, we should examine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders.

The premise is that these arrangements, perhaps well intentioned when adopted, have morphed into entitlements that may not align with shareholders' interests, may not motivate performance, and may, in fact, "reward top executives even if their shareholders lose value."

Comment: Treasury does not advocate their elimination, but rather that their need and usefulness be reexamined. These arrangements are possibly appropriate for mid-career hires who have not built up income or capital, but they could be sun-setted when they become redundant and cause the total "walk-away" number to become excessive.

5. Finally, we should promote transparency and accountability in the process of setting compensation.

Treasury advocates greater independence and accountability for compensation committees and greater clarity in disclosure of compensation practices and termination benefits to shareholders. To further this principle, Treasury intends to propose to legislation to empower the SEC (1) to require a non-binding advisory vote for shareholders on executive compensation (say-on-pay), and (2) to enhance the independence of compensation committees and their advisers. Two specific fact sheets accompanying Secretary Geithner's statement give further specifics for the Administration's thinking in these areas. They are attached to this letter because they are worth reading in full. Of particular note, the Treasury is proposing that shareholders have two annual say-on-pay votes: (1) on the compensation program as disclosed in the CD&A and pay tables, and (2) on the actual compensation paid to the named executive officers as reported in the Summary Compensation Table.

SEC Statement

The statement by the Chairman of the SEC, Mary Schapiro focuses on enhanced disclosure. Specifically, the SEC is currently considering, and will likely propose for comment in the next two months, enhancements to proxy disclosure, including:

- How the board manages risk, including compensation risk,
- The company's overall approach to compensation, including pay-risk management,
- Compensation consultants' conflicts of interest,
- Qualifications and experience of director nominees, and
- Why the board has separated or combined the positions of board chair and CEO.

Her statement strongly supports the SEC's recent proposal to allow shareholder access to proxy statements to nominate an independent slate of directors.

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This letter is intended to alert compensation professionals about developments that may affect their companies. Questions of applicability to a specific company situation should be directed to the appropriate advisers. General questions about this letter may be directed to Fred Cook at (914) 460-1101 or fwcook@fwcook.com, Wendy Hilburn at (212) 299-3707 or wjhilburn@fwcook.com, or Kathryn Neel at (914) 460-1103 or klneel@fwcook.com.

<u>Fact Sheet</u>
Ensuring Investors Have a "Say on Pay"

Today, the Administration is calling for "say-on-pay" legislation, long supported by President Obama, that would give the SEC the authority to require non-binding annual say-on-pay votes for all public companies.

1. ***<u>Improve board accountability and better align compensation with long term value creation for shareholders</u>:*** Say-on-pay will improve directors' accountability to the owners of the company by giving shareholders a way to express their views on executive compensation , and will allow boards and shareholders to work together to design compensation that gives executives strong incentives to maximize long-term firm value. President Obama co-sponsored say-on-pay legislation while in the Senate, and the United Kingdom adopted say-on-pay legislation in 2002. Recognizing that say-on-pay permits directors to benefit from shareholder perspectives in designing compensation, several American companies have recently voluntarily permitted say-on-pay votes. Although 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.

2. ***<u>Authorize the SEC to require non-binding say-on-pay votes for all public companies</u>***

   i. ***<u>Shareholders in public companies will have the right to cast a non-binding vote each year approving or disapproving executive pay packages</u>:*** 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. ***<u>Shareholders will vote on annual compensation, including salary, bonus and other forms of compensation for the top 5 executives</u>***: 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.

      o 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.

   iii. ***<u>Companies will have the opportunity to include additional resolutions on specific compensation decisions:</u>*** Companies will have the opportunity to ask shareholders' views on specific compensation decisions, including decisions related to various aspects or categories of pay. Each company, however, will be required to permit shareholders to vote on a resolution addressing all of the compensation disclosed in the annual proxy.

   iv. ***<u>Shareholders will have the right to cast a non-binding vote on golden parachutes</u>***: Consistent with the say-on-pay legislation President Obama co-sponsored while in the Senate, shareholders 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.

<u>Fact Sheet</u>
Providing Compensation Committees With New Independence

We will propose legislation that will give compensation committees greater independence, just as Sarbanes-Oxley did for audit committees. The legislation will direct the SEC to promulgate rules requiring companies listed on national securities exchanges to meet exacting standards for independence. Under these rules, not only would compensation committee members be truly independent from management, but the committee's compensation consultants and legal counsel would be answerable only to the committee. This legislation will direct the SEC to:

1. ***<u>Issue rules requiring that compensation committee members meet independence standards similar to audit committee members under Sarbanes-Oxley</u>***: 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. This high standard will ensure that compensation committee members will be truly independent when setting executive pay on behalf of shareholders.

2. ***<u>Issue rules giving compensation committees the authority and tools they need to be truly independent</u>***: 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:

   i. *Authority over compensation consultants.* 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.

   ii. *Authority to engage legal counsel*. The compensation committee must have the authority to engage counsel and other advisers, as it determines necessary to carry out its duties.

   iii. *Funding*. 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.

3. ***<u>Provide standards for the independence of compensation consultants and outside counsel</u>***: Shareholders should have confidence that the compensation committee has the benefit of objective, expert advice. Studies have shown that the use of consultants with conflicts of interest may lead to an increase in the compensation paid to top managers. 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.