Obama Administration Proposes New Executive Compensation Rules

Critics of public-company executive compensation were becoming increasingly vocal even before Congress imposed stringent executive pay restrictions on recipients of federal bailout money. Businesses and commentators speculated how–if at all–the Obama Administration would seek to regulate executive pay practices generally. Last week's June 10, 2009 release of a broadly-outlined proposal for reform in the public-company arena gives some hint of direction: the Administration has disclaimed any interest in pay caps but has said that it wants more effective and independent director oversight and control and a closer alignment of pay with corporate performance. So far, the Administration's announced agenda on executive pay is limited to an enhanced role for the Securities and Exchange Commission (SEC) and does not, at this juncture, propose additional tax rules to limit executive pay.

At the same time that the Administration unveiled its public-company proposals, the U.S. Department of the Treasury (Treasury) also issued interim final executive compensation rules for participants in the Troubled Asset Relief Program (TARP), including provision for a new compensation "special master," who was appointed on the same day the rules were released.

The purpose of this Alert is to summarize the Administration's proposals and certain other pending legislative and regulatory activity affecting executive compensation.

I. Treasury Proposals Affecting Executive Compensation Generally

Although the TARP was specifically directed at participating financial institutions, some practitioners wondered if some of the TARP's executive compensation restrictions would become so-called "best practices" for other companies or would be expanded to cover companies beyond those in the TARP. The Administration's proposals of last week and their reappearance in the White House's June 17 proposal for financial regulatory reform indicate that the answer may well be "yes."

A. Announcement of Broad Principles to Guide Executive Compensation Reform

As part of the Administration's proposal, Treasury Secretary Timothy F. Geithner announced general guidelines for shaping future reforms of executive compensation. In contrast to the Administration's related (but separate) legislative proposal to give the SEC enhanced rule-making power over public company executive pay practices, described further below, it is not clear whether any of these guidelines will reappear eventually as legislative initiatives. The proposed general guidelines are as follows:

- *"First, compensation plans should properly measure and reward performance."* Performance-based compensation should be aligned with long-term value creation, based on a variety of metrics including individual, business unit, and firm performance, as well as performance relative to peer firms. The Secretary's guidelines single out for criticism pay incentives based solely on stock price.

- *"Second, compensation should be structured to account for the time horizon of risks."* In the Secretary's words, incentives should be "tightly aligned" with long-term value and soundness. The guidelines note that requiring stock to be held for a longer time period may be part of the answer, although they are careful to stress that "directors and experts should have the flexibility to determine how best to align incentives in different settings and industries."
- *"Third, compensation practices should be aligned with sound risk management."* The guidelines urge compensation committees to conduct and publish risk assessments of pay packages and state that firms should give greater authority to risk managers who can help balance incentives and risk-taking. The TARP legislation applied similar principles to institutions participating in the TARP, and some non-TARP employers have already begun to consider these practices in light of the TARP principles. While it remains to be seen how many companies will voluntarily adopt these practices, some have already begun to discuss with consultants how they can address risk concerns when designing incentive compensation programs. Some practitioners believe that consideration of risk issues may become "best practices" whether or not required by law.
- *"Fourth, we should reexamine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders."* The guidelines express general skepticism as to whether "golden parachutes" and supplemental retirement benefits are in all cases properly aligned with the interests of shareholders.

B. Giving Public Company Shareholders a Non-Binding Say-on-Pay Vote and Other Proxy Reforms

Secretary Geithner also announced that the Administration will work with Congress to pass legislation authorizing (and, presumably, encouraging) the SEC to require a non-binding "up or down" vote on public-company executive-pay packages as disclosed in a company's proxy (including both the narrative "CD&A" description and the quantitative disclosure). This "say-on-pay" approach has a parallel in a number of initiatives already underway in Europe.

Under the announced Administration proposal, shareholders would have the ability to express their views on a broad range of compensation practices. For a company's named executive officers, the vote, albeit non-binding, would cover both specific components such as equity awards as well as "total compensation" as computed under the proxy rules. Shareholders could also cast non-binding votes to approve or disapprove golden-parachute payments disclosed in proxy statements disseminated in connection with transactions that may involve a change in control of the company.

Also on June 10, 2009, SEC Chairman Mary Schapiro announced that the SEC was considering several proposals requiring greater proxy disclosure, including disclosure of how companies and their boards manage risk, how boards of directors choose their leadership structure, overall approach to compensation (including with respect to non-executive employees), potential conflicts of interests of compensation consultants, and the experience and qualifications of director nominees. These measures follow the SEC's proposed rule amendments last month to facilitate shareholder rights under state law to nominate and elect members of the board of directors.

C. Authorizing the SEC to Require Greater Compensation-Committee Independence

The Administration's proposal would have the SEC issue rules to require public company compensation committees to meet stringent independence standards similar to those currently imposed on audit committees. The compensation committee would be directly responsible for the appointment, compensation, retention and oversight of any compensation consultants retained by the company (with the consultants reporting directly to the committee), would have the authority to engage outside counsel and other advisors, and could determine how much to pay these consultants and advisors. In addition, the SEC would be charged with establishing compensation committee independence standards.

II. Recent Developments Affecting Executive Compensation at TARP Companies

Last week also saw new rules affecting recipients of TARP funds and the appointment of a Special Master for TARP Executive Compensation as noted below.

A. Interim Final Rules on TARP Standards for Corporate Governance and Executive Compensation

Treasury issued detailed interim final rules, pursuant to the Emergency Economic Stabilization Act of 2008 (EESA) and the American Recovery and Reinvestment Act of 2009 (ARRA), governing executive compensation at companies receiving TARP assistance and effective generally June 15, 2009. These replace prior EESA rules that were to some extent effectively modified by ARRA.

B. Appointment of a New Executive Compensation Czar

Also on June 10, 2009, Treasury appointed Kenneth R. Feinberg as Special Master for TARP Executive Compensation. In that role, he has the authority (i) to oversee executive compensation at companies that have received "exceptional assistance" under the federal relief program (currently, AIG, Bank of America, Citigroup, Chrysler, Chrysler Financial, General Motors and GMAC) and (ii) to advise on pay at other TARP companies and exercise certain limited discretion with respect to such companies. For companies receiving exceptional assistance, Mr. Feinberg will set salaries and bonuses of top employees (generally, the senior-executive officers and 20 most highly paid) and review and approve the compensation structure for the 100 most highly paid employees not subject to the restrictions and any executive officers not among the 100 most highly paid employees. For other TARP companies, Mr. Feinberg will advise on compensation structures, without setting compensation caps, and also has the discretion to subject executives to clawbacks of compensation based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

The Administration proposals come against the backdrop of a large number of legislative proposals having executive compensation as their focus. As in past years, many of these proposals have little chance of passage, and even those with meaningful support face an uncertain future. However, the history of legislative action, particularly in the area of executive compensation, illustrates the importance of keeping track of all proposals (even failed ones), which frequently contain provisions that reappear in future bills that have a greater chance of becoming law. For legislative proposals and other recent developments relating to executive compensation, see the Annex to this Alert.

If you would like to discuss these or any other tax or executive compensation matters, please contact Renata Ferrari (Boston), Andrew Oringer (New York) or Jon Zorn (Boston); any member of the Tax & Benefits Department or Securities & Public Companies Practice Group; or your usual Ropes & Gray advisor.

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