Treasury Proposes Legislation on Say-on-Pay and Compensation Committee Independence

On July 16, the Treasury Department delivered to Congress draft legislation—the Investor Protection Act of 2009—that would require all public companies to have a non-binding advisory "say-on-pay" vote on executive compensation for any annual meeting held after December 15, 2009. In addition, the proposed legislation would require more stringent independence standards for compensation committee members of listed companies, similar to those now required of audit committee members. The proposed legislation would require the Securities and Exchange Commission to promulgate standards of independence for compensation consultants, legal counsel and other advisers to the compensation committee. This proposed legislation is part of the Obama Administration's ongoing pursuit of greater transparency in the financial markets and executive compensation matters and comes on the heels of recent SEC rule proposals regarding executive compensation disclosure and shareholder proxy access (which we will discuss in a separate Alert to be distributed today), as well as the Treasury Department's recent legislative proposal regarding registration of private investment fund advisors. The Administration's draft legislation can be found here.

Say-on-Pay

The proposed legislation would require a non-binding advisory vote on executive compensation disclosed pursuant to the Commission's proxy rules, which include the compensation committee report, the CD&A, the compensation tables, and related narrative disclosure. The requirement would apply to any annual meeting held after December 15, 2009. Although the proposed legislation directs the Commission to promulgate any necessary rules within one year after adoption, it is not clear that any rulemaking would be required for this aspect of the legislation to be effective for next year's proxy season.

In addition to "say-on-pay," the proposed legislation would require at any meeting called for the purpose of approving a business combination (e.g., a merger, consolidation or sale of assets) a non-binding shareholder vote on "golden parachutes." The proxy material for the business combination would be required to disclose "in a clear and simple tabular form in accordance with regulations to be promulgated by the Commission" [emphasis added] any agreements or understanding with either the target company or the acquiring company about any type of compensation that "is based on or otherwise relates" to the business combination. The potential reach of this disclosure is quite broad. Because this part of the legislation appears to require Commission rulemaking, it is not clear how it would be implemented if that rulemaking is not completed before December 15.

Compensation Committee Independence

The proposed legislation would enact a new Section 10B of the Securities Exchange Act of 1934, which would establish more stringent standards relating to compensation committees. It follows the way in which the Sarbanes-Oxley Act established stricter standards for audit committees—namely, by requiring the Commission to direct the national securities exchanges to prohibit the listing of an issuer that does not comply with the standards set forth in the legislation applicable to compensation committees. They are:

- Independence for Committee Members. A compensation committee member may not receive any consulting, advisory or other compensatory fees and may not be an "affiliated person" of the issuer or any of its subsidiaries. Because this is the same standard that applies to audit committee members, it should be familiar territory for listed companies. Holding another committee to this elevated standard, however, may only increase the difficulty in finding qualified committee members.
- Independence Standards for Advisers. The Commission would be required to promulgate rules establishing independence standards for compensation consultants, legal counsel and other advisers to the compensation committee. Presumably the place the Commission might start is with the rules for "independent legal counsel" to mutual fund boards under the Investment Company Act. This aspect of the proposed legislation raises the specter that disclosure of possible conflicts, such as with the recent Commission rule proposal for compensation consultants, may not be enough and that outright prohibitions may apply. Would the rules, for example, prohibit a company's inside counsel or regular outside counsel from rendering advice to the compensation committee?
- Authority to Retain Compensation Consultants. The compensation committee of each listed company would have to possess the authority to engage an independent compensation consultant and be directly responsible for the oversight of its work. In the proxy material for its annual meeting held one year after enactment of the legislation, an issuer would have to disclose whether it obtained the advice of an independent compensation consultant and, if it did not, it would have to provide an explanation of its basis for determining not to do so.
- Authority to Engage Independent Legal Counsel and other Advisers. The compensation committee would have to possess the authority to retain independent legal and other advisers and would be responsible for oversight of these advisers.
- Funding. Each listed company would have to provide appropriate funding for the compensation committee to pay the fees of the consultants and advisers it retains.

The last three items are standard practice in most compensation committee charters and as a result, if adopted, would be unlikely to have much practical effect. The Commission has the authority to exempt certain categories of issuers from the requirements summarized above and is directed to take into account the potential impact of such requirements on smaller reporting companies.

These proposals further demonstrate the Obama Administration's strong interest in ensuring a greater degree of transparency and accountability in setting executive compensation. Given the recent activity by the Commission and the Administration, we are likely to see enhanced disclosure implemented in time for next year's proxy season. In fact, Representative Barney Frank (D-Mass.), who chairs the House Financial Services Committee, is reported to have said that this committee may vote by the end of July on the proposed legislation, and that he predicted a markup session as early as next week.

If you would like to discuss these or any other governance, executive compensation, or securities law matters, please contact any member of the Securities & Public Companies Practice, the Tax & Benefits Department or your usual Ropes & Gray advisor.