House Approves Legislation Regulating Financial-Institution Compensation and Requiring Say-on-Pay and Compensation Committee Independence

On July 31, 2009, the U.S. House of Representatives passed the Corporate and Financial Institution Compensation Fairness Act of 2009 (the "Act"). If enacted in its current form, the Act would impose significant regulatory constraints on compensation arrangements maintained by "covered financial institutions" (CFIs). CFIs would include banks, credit unions, registered broker-dealers, investment advisors, Fannie Mae, Freddie Mac, and other financial institutions identified by regulators. An institution with assets of less than $1 billion would be exempt. Closely tracking legislation that was delivered to Congress by the Treasury Department in July, the Act would also require a non-binding shareholder vote on the compensation of a public company's named executive officers (say-on-pay) and would mandate that each member of a public company's compensation committee be independent.

For Ropes & Gray Alerts covering earlier Administration proposals and a prior version of the Act, see Treasury Proposes Legislation on Say-on-Pay and Compensation Committee Independence and House Proposal Could Regulate Private Fund Compensation.

Disclosure and Regulation of Incentive-Based Compensation

Under the Act, regulators have nine months to issue regulations requiring disclosure that will enable the regulators to determine whether a CFI's incentive compensation (1) is aligned with sound risk management, (2) is structured to account for the time horizon of risk, and (3) meets such other criteria as the regulators may establish. Within this same nine-month period, the regulators are to prescribe rules that prohibit any incentive-based payment arrangements they determine encourage inappropriate risk that could threaten the safety and soundness of the CFI or could more generally have serious adverse effects on economic conditions or financial stability. No regulation, however, may require the recovery of incentive-based compensation under a compensation arrangement in effect on the date of enactment of the Act if the agreement is for a period of 24 or fewer months. The Act uses both "arrangement" and "agreement" in the same sentence, so it is not entirely clear whether the "grandfathering" protection would apply only to bilateral agreements in effect on date of enactment.

As noted above, any financial institution with assets of less than $1 billion would be exempt from these requirements. It is unclear, however, how the $1 billion asset threshold test is intended to be applied. By its literal terms, it appears to exempt any institution whose own assets are less than $1 billion. A test that looks to an institution's own assets without regard to assets under management could exempt many advisors. On the other hand, assets "of" an advisor or other institution could conceivably be construed as including intangible assets such as goodwill. Further, although the Act requires that the "appropriate" Federal regulators jointly prescribe rules to prohibit the compensation arrangements described above, the language of the Act could be read broadly to permit the regulation of advisors and funds that are currently unregulated, if such advisors or funds were sufficiently large in size.

The Act would also require the GAO to study and report, within one year of enactment, the correlation between excessive risk-taking and compensation structures of companies between 2000 and 2008, comparing companies that failed or nearly failed (but for government assistance) with those companies that remained viable throughout the economic crisis of 2007 and 2008.

Say-on-Pay

Like the earlier Treasury proposal, the Act would require public companies to solicit a separate, non-binding shareholder vote on compensation disclosed for named executive officers under SEC disclosure rules (including disclosure in the compensation committee report, the CD&A, the compensation tables, and any related materials). The Act would require the SEC to issue final implementing rules within six months of enactment. The say-on-pay vote rules would apply only to annual meetings held six months or more after rules are issued. For this reason, even if the Act were to be enacted without modification later this summer or early this fall, it is likely that calendar year issuers would not have to include a say-on-pay proposal in their proxy statements until the 2011 proxy season.

Additionally, if a payment to a named executive officer is "based on or otherwise related to" a business combination (*e.g.,* a merger, consolidation or sale of assets) for which shareholder approval is sought, the payment would have to be disclosed in the related proxy statement in a "clear and simple form" (but not necessarily in tabular form). Payment arrangements subject to this rule would include arrangements with either the target company or the acquiring company. For any payment or agreement not approved by shareholders as part of the say-on-pay vote, shareholders would be required to have a separate, non-binding vote on such arrangements.

An institutional investment manager subject to Section 13(f) of the Securities Exchange Act of 1934 (generally institutional investment managers with investment discretion over $100 million or more of certain equity securities) would have to report at least annually how it has voted on say-on-pay votes (except any votes otherwise required to be reported publicly).

The SEC would be authorized, when issuing final rules, to create appropriate exemptions, taking into account considerations such as the potential impact on smaller companies.

Compensation Committee Independence

Within nine months of the Act's enactment, the SEC would have to direct the national securities exchanges to prohibit the listing of an issuer's equity (but not debt) if the issuer does not have a compensation committee that (1) is composed entirely of independent members who do not receive consulting, advisory, or compensatory fees other than in their capacities as board or committee members, (2) has authority to retain independent compensation consultants, and (3) has authority to engage independent counsel and other advisors. In any proxy statement for an annual meeting of shareholders (or special meeting in lieu thereof) occurring one year after the Act's enactment, issuers would also be required to disclose whether their compensation committees retained and obtained advice from independent compensation consultants. Unlike the Treasury proposal, the Act would not require an issuer to explain why it did not use independent compensation consultants or require a committee's legal counsel to meet the independence standards.

The SEC would also be required to establish standards of independence for compensation consultants and may exempt particular relationships from those standards. The SEC must also ensure that such regulations are "competitively neutral" among categories of consultants and preserve the ability of compensation committees to retain the services of members of any such categories.

Although the House quickly considered and approved this legislation, it is unlikely that it will be considered by the Senate before it goes on recess at the end of this week. It is currently anticipated that the Act's provisions will be encompassed, in some form, in the regulatory reform legislation that the Senate Banking Committee expects to propose sometime in the fall.

For more information, please contact any member of our Securities & Public Companies practice, the Tax & Benefits department, the Hedge Funds practice or your usual Ropes & Gray advisor.