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Treasury Secretary Signals Direction of Executive Compensation Reform

Treasury Secretary Tim Geithner issued a public statement on June 10, 2009 outlining five broad-based principles intended to bring compensation practices more in line with the interests of shareholders and reinforce the stability of firms and the financial system. Along with the statement of principles, Treasury released two fact sheets – one on shareholder "say-on-pay" and one on compensation committee independence.

Background

Executive pay practices are under increased scrutiny, sparked by oversight of executive pay practices of institutions receiving governmental bailout funds under the Emergency Economic Stabilization Act's (EESA) Troubled Asset Relief Program (TARP). (See our October 20, 2008 *For Your Information.*) On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act which contained amendments to the executive pay restrictions under EESA. (See our March 2, 2009 *For Your Information*.) Shareholder advisory groups are becoming increasingly proactive, and have called for the reform of executive compensation practices at many public companies, not just institutions benefitting from TARP funding. In the wake of the economic crisis, the Obama administration has also become active in the debate surrounding executive pay practices.

Geithner Statement

On June 10, 2009, Treasury Secretary Geithner issued a public statement outlining five broad-based principles for executive compensation reform. Notably, he made it clear that there is no intention to cap pay levels or set forth precise prescriptions for how companies should set compensation. The Treasury Secretary further indicated that President Obama's Working Group on Financial Markets will provide an annual review of compensation practices to monitor whether they are creating excessive risks. Academics, business leaders and shareholders will also be encouraged to conduct their own reviews to identify best practices and emerging trends.

Five Guiding Principles

The five broad-based principles are summarized below.

Compensation Plans Should Properly Measure and Reward Performance. Compensation should be tied to performance and align with long-term value creation. Performance bars should not be set too low and benchmarks should not trigger bonuses when a firm is underperforming relative to its peers. Performance-based pay should be conditioned not just on stock price, but also on other internal and external metrics. These include the firm's performance relative to its peers, an individual executive's performance, the performance of a particular business unit and the firm's overall performance.

Compensation Should Be Structured to Account for the Time Horizon of Risks. Executives should not be rewarded for decision making that encourages short-term gain at the expense of the company's long-term value. Companies should seek to pay top executives in ways that are tightly aligned with the long-term value and soundness of the firm. In addition, firms should carefully consider how proper incentives can extend beyond top executives to those involved at various levels in designing, selling and packaging financial products.

> ***BUCK COMMENT.*** *In addition to a focus on creating long-term value, companies should align incentive pay structures to reinforce strategic objectives over various time horizons. By setting objectives in each of three periods (annual, mid-term, and long-term) and adequately monitoring these periods, companies can avoid purely short-term decision making in setting rewards.*

Compensation Practices Should Be Aligned with Sound Risk Management. Compensation committees should conduct and publish risk assessments of pay packages to ensure they do not encourage imprudent risk taking. Because risk managers in the past lacked the authority necessary to safeguard against risky activities, firms should explore how they can provide risk managers with the tools and authority to manage the relationship between incentives and risk taking.

> ***BUCK COMMENT.*** *Determining what constitutes appropriate versus excessive risk is challenging. A useful first step is for compensation committees to verify that the company's risk management process executed by the board, management, and risk and audit committees is fully transparent and well documented. See Buck's* InsightOut *publication entitled* Corporate Governance – A Risk Sensitized Executive Pay Governance Process (Part One & Part Two).

Reexamination of Whether Golden Parachutes and Supplemental Retirement Packages Align with the Interests of Executives and Shareholders is Necessary. Companies should reexamine how well golden parachutes and supplemental retirement packages are aligned with shareholders' interests, whether they truly provide incentives for performance, and whether they reward top executives even if their shareholders lose value.

> ***BUCK COMMENT.*** *Supplemental executive retirement plans (SERPs) under which certain executives received substantial payouts despite poor corporate performance and depleted shareholder value have attracted considerable attention. Many public companies are reviewing their golden parachute provisions, especially those under which executives not involuntarily terminated are entitled to substantial packages following a change in control.*

In determining the appropriate level of executive pay, companies should consider a comprehensive, contingency-driven analysis that factors in all aspects of an executive's pay package, including SERPs and golden parachute provisions.

Transparency and Accountability Should be Promoted in Setting Compensation. Treasury intends to work with Congress to pass legislation in two specific areas. First, Treasury will support efforts to pass "say on pay" legislation, i.e., giving the SEC authority to require companies to give shareholders a non-binding advisory vote on executive compensation packages. Second, Treasury will propose legislation giving the SEC the power to ensure that compensation committees are more independent, providing standards similar to those for audit committees under the Sarbanes-Oxley Act. Compensation committees would also be given the responsibility and resources to hire their own independent compensation consultants and outside counsel.

BUCK COMMENT. *The principles described above and the fact sheets discussed below are not limited to public companies that have received TARP funds. Therefore, it appears that forthcoming legislation would affect all public companies.*

Fact Sheet on Say-on-Pay

According to the first fact sheet entitled "Ensuring Investors Have a 'Say on Pay'," the Obama administration is calling for proposed legislation as follows –

- All public companies would have to include in annual proxies a shareholder resolution requesting approval or disapproval of executive compensation as disclosed in the proxy.
- Shareholders would have the right to vote on annual compensation for the top five named executive officers, including salary, bonus and other forms of compensation as disclosed in the summary compensation table (e.g., non-equity incentive plan compensation, changes in pension value, option and stock awards).
- Companies would have the opportunity to solicit shareholder views on specific compensation decisions, but must permit shareholders to vote on a resolution addressing all of the compensation disclosed in the annual proxy.
- Shareholders would have an opportunity to cast a non-binding advisory vote to approve or disapprove golden parachute compensation.

BUCK COMMENT. *These provisions are similar to those under the Shareholder Bill of Rights Act of 2009 (S. 1074) introduced on May 19, 2009. In addition, on June 10, 2009, SEC Chairwoman Mary Schapiro issued a statement specifying that the SEC is considering requiring proxy disclosure of how a company (and its board) manages risk, its overall compensation approach, potential conflicts of interest by* *compensation consultants, the experience and qualifications of director nominees and why a board has chosen its particular leadership structure.*

Fact Sheet on Compensation Committee Independence

The second fact sheet, entitled "Providing Compensation Committees With New Independence," indicates legislation will be proposed that will give compensation committees greater independence, just as Sarbanes-Oxley did for audit committees. The SEC will be directed to issue rules for public companies to meet new higher independence standards and have the tools they need to be truly independent, such as authority over compensation consultants, legal counsel, and access to funding, so that committees have the benefit of objective expert advice.

Conclusion

This statement, with input across government agencies, sheds light on the future of executive compensation reform. Buck's consultants are available to help you review your executive compensation practices to ensure they remain in line with the rapid developments in this area.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.