House of Representatives Passes Corporate and Financial Institution Compensation Fairness Act of 2009

August 3, 2009

On July 31, 2009, the House of Representatives passed the Corporate and Financial Institution Compensation Fairness Act of 2009.[1] The bill would:

- amend the Securities Exchange Act of 1934 to give shareholders of public companies a non-binding vote on executive compensation
- impose enhanced independence and other requirements on listed companies' compensation committees
- impose independence requirements on the compensation committee's consultants and other similar advisers and
- require federal regulators to adopt rules for covered financial institutions prohibiting certain incentive compensation arrangements and requiring additional compensation disclosure.

Say-on-Pay

Annual Advisory Vote

The bill would give shareholders of public companies a non-binding advisory vote at annual meetings, or special meetings in lieu of annual meetings, on executive compensation for the named executive officers, as presented in the Compensation Discussion and Analysis and compensation tables included in a company's proxy statement.

Golden Parachutes

In proxy solicitation materials for any meeting where shareholders are asked to approve a business combination or sale of assets, the bill would require all soliciting persons to disclose any compensation arrangements relating to the transaction that the soliciting persons have with the named executive officers of the issuer, or of the acquiring issuer if such issuer is not the acquiring issuer. Disclosure of the total compensation that may be paid or payable, and

[1] The bill has undergone several amendments by the Committee on Financial Services on July 28, 2009 and by the whole House on July 31, 2009 since it was introduced on July 21, 2009. The text of the Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. (2009), as passed by the House, is available here. *See also* our Client Alert of July 28, 2009 entitled "Treasury Department Delivers Investor Protection Act of 2009 to Congress; Related Legislation Introduced in Congress," available here.

the conditions upon which it may be paid or payable, would be made in accordance with new regulations to be adopted by the Securities and Exchange Commission.

Proxies relating to such proxy solicitation material would be required to provide for a separate non-binding advisory vote on these compensation arrangements, unless they had been subject to a shareholder vote under the annual say-on-pay requirement.

Disclosure of Say-on-Pay Votes

The bill now includes a provision that would require certain institutional investment managers[2] to report at least annually on how they voted in annual and golden parachute say-on-pay votes.

Effectiveness

The bill requires the SEC to issue final rules to implement these requirements no later than six months after the enactment of the bill.

The say-on-pay requirements would be effective for meetings held on or after the date that is six months after the SEC issues final rules implementing these requirements.

Exemption from Say-on-Pay Requirements

The bill would authorize the SEC to grant exemptions to certain categories of issuers from the say-on-pay requirements. In determining appropriate exemptions, the SEC would be required to consider the potential impact of these requirements on smaller reporting companies.

Non-US Companies

It appears that the say-on-pay requirements are not intended to apply to "foreign private issuers," as defined in Exchange Act Rule 3b-4(c) because they are specifically tied to disclosure about executive compensation under the SEC's proxy rules, which do not apply to foreign private issuers pursuant to Exchange Act Rule 3a12-3(b).[3]

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[2] The requirement would apply to institutional investment managers subject to Section 13(f) of the Exchange Act, which includes those with investment discretion over accounts holding listed equity securities with an aggregate fair market value of at least $100 million.

[3] However, the SEC would need to amend Rule 3a12-3(b) to include new Section 14(i) of the Exchange Act, which sets forth the say-on-pay requirements.

Compensation Committee Requirements

The bill would require the SEC to adopt rules, effective no later than nine months after its enactment, directing the national securities exchanges and associations to prohibit the listing of any class of equity security of an issuer that is not in compliance with the following requirements.

Independence of Compensation Committee

The bill would require each member of the compensation committee to be independent and would impose stricter independence requirements on compensation committee members. These stricter independence requirements are similar to the first element of those requirements imposed on listed company audit committee members by the Sarbanes-Oxley Act of 2002. To be independent, a compensation committee member may not, other than in his or her capacity as a member of the board or a board committee, accept any consulting, advisory or other compensatory fee from the listed company. In a change from the July 21, 2009 version of the bill, the amended bill no longer includes the prohibition on compensation committee members' being affiliated persons of the listed company or any of its subsidiaries.

In situations where a company does not have an established compensation committee, the term "compensation committee" would include all independent members of the board.

Independence of Compensation Consultants and Other Similar Advisers

The bill would require compensation consultants and other similar advisers to the compensation committee to be independent in accordance with standards to be established by the SEC. The requirement for legal counsel to the compensation committee to be independent was deleted.

Retention of Compensation Consultants, Legal Counsel and Other Advisers

Compensation committees would have the authority, in their sole discretion, to retain and obtain the advice of compensation consultants, legal counsel and other advisers that meet the new independence requirements. The compensation committee would be directly responsible for their appointment, compensation and oversight. Companies would be required to provide appropriate funding, as determined by the compensation committee, for payment of such independent compensation consultants, counsel and other advisers. While the independence requirements for legal counsel to the

compensation committee were deleted in the amended bill, the reference to independent legal counsel was retained in these provisions.

Disclosure Relating to Compensation Consultants

Beginning with annual meetings, or special meetings in lieu of annual meetings, held one year after the date of enactment, the bill would require listed companies to disclose in their proxy statements whether their compensation committees have retained and obtained advice from compensation consultants that meet the new independence standards. The disclosure requirement for the company to explain the basis for the compensation committee's determination that retaining an independent consultant was not in the shareholders' interests was deleted.

Study on Use of Compensation Consultants and Effects of Such Use

The bill directs the SEC to conduct a study on the use of compensation consultants that meet the new independence standards and the effects of such use and to submit a report to Congress within two years after the effective date of the new SEC rules.

Exemption Authority

The SEC is authorized to provide exemptions for certain categories of issuers, such as smaller reporting companies or foreign private issuers.

Non-US Companies

The SEC rules and listing standards to be adopted to implement these requirements would most likely apply to both US and non-US listed companies, as is the case with respect to the audit committee requirements in Section 10A(m) of the Exchange Act and Exchange Act Rule 10A-3. The SEC may grant foreign private issuers limited exemptions from the compensation committee requirements, as it did with respect to the audit committee requirements, and from the disclosure requirement relating to compensation consultants, since foreign private issuers are not subject to the SEC's proxy rules.

COVERED FINANCIAL INSTITUTION INCENTIVE-BASED COMPENSATION

The bill would require the appropriate federal regulators[4] jointly to adopt rules, no later than nine months after the enactment of the bill, as follows:

Disclosure of Incentive-Based Compensation

Covered financial institutions[5] would be required to disclose to the appropriate federal regulators the structure of all incentive-based compensation arrangements. The disclosure must be sufficient to determine whether the compensation structure:

- is aligned with sound risk management
- accounts for the time horizon of risks and
- meets any other criteria determined by the appropriate federal regulators to reduce unreasonable incentives offered by the institutions for employees to take undue risks that could:
  - threaten the safety and soundness of the covered financial institution or
  - have serious adverse effects on economic conditions or financial stability.

The bill clarifies that covered financial institutions would not be required to:

- report actual compensation of particular individuals or
- make disclosure pursuant to these requirements if they do not have incentive-based compensation arrangements.

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[4] "Appropriate federal regulators" is defined as the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC and the Federal Housing Finance Agency.

[5] "Covered financial institution" is defined as (i) a depository institution or depository institution holding company, as such terms are defined in Section 3 of the Federal Deposit Insurance Act, (ii) a broker-dealer registered under Section 15 of the Exchange Act, (iii) a credit union, as described in Section 19(b)(1)(A)(iv) of the Federal Reserve Act, (iv) an investment adviser, as such term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940, (v) the Federal National Mortgage Association, (vi) the Federal Home Loan Mortgage Corporation and (vii) any other financial institution that the appropriate federal regulators determine should be treated as a covered financial institution.

Prohibition on Certain Incentive-Based Compensation Arrangements

Any incentive-based compensation arrangement, or a feature of such an arrangement, that encourages covered financial institutions to take inappropriate risks would be prohibited if the risks could:

- threaten the safety and soundness of the covered financial institution or
- have serious adverse effects on economic conditions or financial stability.

Recovery of Incentive-Based Compensation

The bill would prohibit any new regulations that require the recovery of incentive-based compensation under compensation arrangements in effect on the date of enactment of the bill, provided such arrangements have a term of 24 months or less. However, the bill would not prevent or limit the recovery of incentive-based compensation under any other applicable law.

Exemption for Certain Financial Institutions

Covered financial institutions with assets of less than $1 billion would be exempt from these provisions.

Study on Correlation between Compensation Structures and Excessive Risk Taking

The bill directs the Comptroller General to conduct a study to determine whether there is a correlation between compensation structures and excessive risk taking. This study would:

- consider compensation structures used from 2000 to 2008 and
- compare companies that failed, or nearly failed but for government assistance, to companies that remained viable throughout the housing and credit market crisis of 2007 and 2008.

The Comptroller General would be required to report to Congress the results of this study within one year after the enactment of the bill.

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