Corporate Governance Reforms and Executive Compensation – The Perfect Storm

JUNE 24, 2009

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Over the next few months we are likely to witness the development of a "perfect storm" of corporate governance reforms and executive compensation changes at U.S. public companies. The magnitude of the 2008 – 2009 financial crisis, the perception that the global recession was caused in part by compensation programs that encouraged executives to take inappropriate risks, and widespread popular dissatisfaction with current pay practices and governance standards are aligning in ways that are likely to cause major turmoil for public companies. Rules proposed by the SEC and the Treasury Department, and pending legislation, would facilitate shareholder proxy access in director elections and require majority voting for directors in uncontested elections. In addition, an NYSE rule change would eliminate discretionary broker voting for directors in uncontested elections. All of these developments will put pressure on public companies to find new ways to reach out to shareholders to solidify support for the board. As a result, the 2010 proxy season is shaping up to be one of profound changes, and companies are well advised to keep these developments in mind while planning their executive compensation programs.

A. Treasury Department Initiatives

On June 10, 2009 the Treasury Department issued executive compensation proposals that, if adopted, will affect the executive compensation and corporate governance practices of virtually all U.S. public companies across all industries. In particular, the Treasury proposals would impose mandatory "Say-on-Pay" shareholder vote requirements and new requirements for compensation committee independence.

Statement of Principles

Secretary Geithner's statement laid out five broad principles that are meant to apply particularly to financial institutions, but also extend to all companies. They are principles, rather than prescriptions, and are expected to evolve over time with the help of industry and expert advice. The goal of this effort is to "develop standards that reward innovation and prudent risk-taking without creating misaligned incentives." The five principles that the Treasury Department believes should guide proposed legislation and future regulation are as follows:

1. Compensation should properly reward performance.

The goal is to have incentives for performance leading to long-term value creation measured by a "wide range of internal and external metrics, not just stock price." In testimony before the House Financial Services Committee, a member of Mr. Geithner's staff expanded upon this first principle by saying, "Performance pay based solely on stock price can on the one hand, 'confuse brains for a bull-market' and in the other scenario, fail to recognize exceptional contributions by executives in difficult times. A thoughtful mix of performance metrics could include not only stock prices, but individual performance assessments, adherence to risk management and measures that account for the long-term soundness of the firm."

2. Compensation should be structured to account for the time horizon of risks.

The Treasury advocates paying "top executives in ways that are closely aligned with the long-term value and soundness of the firm." Paying in stock that would be held for longer periods of time is advocated as one way, but not the only way, to do this. Long-term performance plans where value is lost if strong performance in one year is followed by weak performance in another has been mentioned as another approach. The idea is to match compensation outcomes with risk outcomes, for both top executives and other key employees.

3. Compensation practices should be aligned with sound risk management.

The premise of this principle is that imprudent risk-taking was often not checked by risk controls because "risk managers too often lacked the stature or the authority necessary to impose a check on these activities." Treasury calls upon compensation committees to conduct and publish pay-risk assessments and "provide risk managers with the appropriate tools and authority to increase their effectiveness."

4. Golden parachutes and supplemental retirement packages should be examined for alignment of the interests of executives with those of shareholders.

The premise is that compensation arrangements of this sort, even if well intentioned when adopted, have morphed into entitlements that may not align executive interests with shareholder interests, may not motivate performance, and may actually "reward top executives even if their shareholders lose value."

5. Transparency and accountability in the compensation-setting process should be promoted.

Treasury advocates greater independence and accountability for compensation committees and greater clarity in disclosure of compensation practices and termination benefits to shareholders.

"Say-on-Pay"

The Treasury Department proposed legislation, applicable to any company listed on a national securities exchange such as the NYSE or NASDAQ, that would establish "Say-on-Pay" shareholder votes. The legislation would:

- Authorize the SEC to require public companies to include, in their annual proxy statements, a resolution requesting non-binding shareholder approval or disapproval of disclosed executive compensation (including the Compensation Disclosure and Analysis narrative and the amount of executive compensation).

- Give shareholders the right to a non-binding vote on annual compensation for the top five named executive officers, including all compensation described in the CD&A and covered by the summary compensation table. Companies could also choose to solicit shareholder views on specific compensation decisions.

- Give shareholders the right to cast a non-binding vote to approve or disapprove golden parachute compensation spelled out in the proxy solicitation materials for shareholder votes to approve a merger, acquisition or other possible change of control.

Compensation Committee Independence

The Treasury Department also proposed, for any company listed on a national securities exchange, that new standards be applied to the compensation committee that are similar to those provided for audit committees under the Sarbanes-Oxley Act of 2002. The legislation would require the SEC to:

- Issue rules requiring compensation committee members to meet higher standards for independence, as is required for audit committee members currently.

- Give compensation committees the power to engage counsel and other advisors and require companies to establish funding to engage and adequately compensate advisors employed by the compensation committee. Compensation consultants would report directly to the compensation committee, and be answerable only to it. The compensation committee would be directly responsible for the appointment, compensation, retention and oversight of any compensation consultants it retains.

- Establish standards for ensuring the independence of compensation consultants and outside counsel used by the compensation committee.

It is not yet clear whether these proposals will require (as is the case with audit committees) that the compensation committee include only independent directors and identify a member who is a "compensation expert."

B. SEC Proposals

The Securities and Exchange Commission recently proposed rules that would allow shareholders to nominate directors in opposition to a management slate and have their nominees included in the company's annual meeting proxy statement. To be eligible to do so, shareholders must hold a specified percentage of the company's voting securities, which varies depending on the company's public float:

- Large accelerated filer ($700 million of public float) – stockholdings of 1% or more;
- Accelerated filer ($75 million of public float) – stockholdings of 3% or more; and
- Non-accelerated filer (below $75 million of public float) – stockholdings of 5% or more.

In another manifestation of the growing focus on the structure and corporate governance of public company executive compensation, on June 10, 2009, the SEC announced it was considering new proxy disclosure rules that would focus on greater disclosure of risk management policies and potential conflicts of interest for compensation committees. SEC Chairman Mary Schapiro announced that the agency is currently considering, and will likely propose for comment in the next two months, enhancements to proxy disclosure, including:

- How the board manages risk, including compensation risk;
- The company's overall approach to compensation, including pay-risk management;
- Compensation consultants' conflicts of interest;
- Qualifications and experience of director nominees; and
- Why the board has separated or combined the positions of board chair and CEO.

Risk management disclosures, while innocuous on the surface, may prove troublesome for directors serving on compensation committees if, as seems likely, companies are required to disclose their views on whether stock options, performance-vesting restricted stock units, or other forms of equity awards encourage executive risk-taking behavior.

C. The Shareholder Bill of Rights Act of 2009

On May 19, Senators Schumer and Cantwell introduced legislation that would federalize elements of corporate governance traditionally left to state corporate law. In particular, the bill would confirm that the SEC has authority to regulate proxy access in director elections, set requirements for shareholder proxy access, and provide new federal standards for corporate governance, as described below.

Proxy Access

The Shareholder Bill of Rights Act would require the SEC to establish rules relating to shareholder proxy access. However, the bill would impose limitations on the SEC's rules. In order for a shareholder to be entitled to include director nominee information in the company's proxy materials, the shareholder would have to meet the following requirements:

- Minimum beneficial ownership of 1 percent of the voting securities; and
- Shares must be held for a minimum of 2 years preceding the date of the next scheduled annual meeting.

Corporate Governance Standards

The Shareholder Bill of Rights Act would federalize aspects of corporate governance, by requiring the SEC to direct the NYSE and NASDAQ to set new corporate governance standards for listed companies, as follows:

Independent Board Chair

The bill would require that an independent director serve as chair of the board of directors, and would prohibit former company executives from serving as chair.

Annual Director Elections

The bill would require directors to stand for election annually. This would eliminate the staggered board, a powerful antitakeover mechanism.

Majority Voting for Uncontested Elections

The bill would require that nominees in uncontested elections be elected by a majority of votes cast, and would require resignation by directors not receiving a majority vote. The bill would allow for plurality voting in contested elections.

Risk Committee

The bill would require listed companies to establish a committee of independent directors to oversee the establishment and evaluation of the company's risk management practices.

D. NYSE Rule Change

The New York Stock Exchange recently re-submitted to the SEC a proposal that would eliminate discretionary voting by brokers in uncontested director elections. NYSE Rule 452 currently allows brokers to exercise discretionary voting authority – and thus vote – on matters that the NYSE considers "routine." Voting to elect directors in uncontested matters has until now been considered routine, and brokers have historically voted as recommended by the board, in favor of the slate of directors. More recently, some brokers have begun to vote the uninstructed shares in proportion to the actual votes of other client accounts. Because NYSE Rule 452 applies to brokers, it governs how they vote shares of companies listed on other exchanges, such as the NASDAQ. If adopted by the SEC by August 31, 2009, the rule change will apply to proxy voting for meetings held on or after January 1, 2010.

Elimination of routine broker voting for directors in uncontested elections is generally expected to reduce the number of shares voted at the annual meeting. Institutional investors generally vote their shares, but only a minority of retail investors do so (directly or by instructing their broker for shares held in an account). Unless issuers take steps to increase retail interest in voting, this could make it more difficult for some companies to obtain a quorum for the transaction of business at the annual meeting. For companies requiring a majority vote for the election of directors, the rule change would make it harder to achieve that threshold. We would expect institutional investors to find their influence increasing, and we would expect companies to experiment with outreach to individual shareholders to solicit their support. In combination with current trends in executive compensation and the public sensitivity to executive pay, elimination of discretionary voting promises to make the 2010 proxy season particularly volatile.

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The legislative and regulatory proposals outlined above, while seemingly straightforward, give rise to many issues and competing principles or interests. The common themes of proxy access and focus on long-term compensation and accountability for risk-taking are at the forefront of the policy debate in Washington. While it is difficult to predict the specific details of reforms, it is likely that the general concepts reflected in such proposals will be reflected in new legislation or regulation.

We expect intense lobbying both for and against these proposals, so it is unclear what form any legislation and rules, if adopted, will take. Fenwick & West will continue to furnish information about these matters as proposals are announced and debated.

Please contact Scott Spector, Horace Nash, Dan Winnike, Jeff Vetter, Blake Martell, your regular Fenwick & West contact, or any member of our corporate securities or securities litigation practices, with any questions you may have about these matters and the potential implications for your company.

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