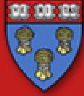
The Harvard Law School Forum on
Corporate Governance and Financial Regulation

Executive Compensation for the 2009-2010 Season

Posted by Charles M. Nathan, Latham & Watkins LLP, on Friday November 20, 2009

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Policy Drivers in the Current Environment — As public companies, Boards and Compensation Committees begin to make year-end 2009 compensation decisions, draft proxies for their 2010 shareholder meetings and design 2010 executive compensation plans, they face many challenges caused by the uncertain economic environment, limited visibility for future business prospects, public anger over executive compensation and increased activity by proxy advisors, institutional shareholders and corporate activists, as well as looming legislative and regulatory changes aimed at executive compensation and related corporate governance.

TARP Participants and Banks — The more than 300 TARP participants are dealing with stringent new compensation limits imposed by Kenneth Feinberg, the Special Master for TARP Executive Compensation. All banks regulated by the Federal Reserve (the Fed) will be required to review their incentive compensation arrangements and governance processes relative to risk under the Fed's unprecedented pay guidelines and review policies.

Other Companies — For companies outside of TARP and the financial sector, thankfully there is now a lull in the storm over executive compensation which gives them an opportunity to survey the scene and take deliberate steps to review compensation programs and improve governance processes heading into 2010 and also plan for the likely "say on pay" vote in 2011.

To prepare for these changes, all companies must first understand the current status of legislative and regulatory developments, the prospects for more changes and the 2009 activities of proxy advisors and institutional shareholders. Companies then need to address these developments and challenges in making their year-end decisions.

The following are important questions and summary answers on these matters, as previously covered in a recent Latham & Watkins webcast, **Kicking Off the 2009 Executive Compensation Season: A Real-time Discussion of Critical Issues and Looming Legislative and Regulatory Changes**. To view the webcast, download it as a podcast and download additional materials,

please click here or go to www.lw.com and visit the Webcast and Podcast archive under the Resources menu.

Special thanks to Roger Brossy and Blair Jones of Semler Brossy for participating in our Webcast and contributing to this *Client Alert*.

Here are the questions we are hearing since the webcast; our answers follow. We hope that they are helpful to you.

The Questions

1. What are the major corporate governance reforms that will affect executive compensation practices in the current environment and beyond?

2. What are the major legislative and regulatory drivers aimed directly at executive compensation that will affect executive compensation practices?

3. What is the status and nature of the SEC's additional proxy disclosure requirements?

4. What do the SEC's proposed rules require regarding risk disclosure and what should companies be doing now to address these issues?

5. What is "say on pay" and what is its US history?

6. What is the likelihood of the enactment of a requirement that all public companies allow their shareholders to have a "say on pay"?

7. What has been the outcome of shareholder votes on executive compensation?

8. To what extent did proxy advisory services, such as RiskMetrics Group (ISS), institutional shareholders and shareholder activists impact executive compensation policies in the 2009 proxy season?

9. Given the growing influence of proxy advisors, institutional investors and shareholder activists, and the unprecedented level of legislative and regulatory developments aimed at executive compensation, what should companies be doing now to prepare for increased scrutiny of and added pressure on executive compensation plans and policies?

10. How should companies and Compensation Committees use pay surveys and other market data this year?

Our Answers

1. What are the major corporate governance reforms that will affect executive compensation practices in the current environment and beyond?

Reforms already in effect — On July 1, 2009, the SEC approved an amendment to NYSE Rule 452 which effectively eliminates broker discretionary voting in uncontested director elections. Specifically, the rule prohibits brokers holding shares in "street name" for their clients from voting in uncontested director elections on behalf of their clients without receiving specific voting instructions from those clients. Since it is estimated that brokers typically control approximately 20 percent of the votes at public companies and historically support management in their votes, the new voting restrictions will likely have a significant impact on the outcome of director elections.

Reforms on the horizon — Congress is considering mandating majority voting in uncontested director elections while the SEC has also proposed allowing shareholder director nominees to be included in companies' annual proxy statements.

- Both the proposed *Shareholder Bill of Rights Act of 2009* (Senator Charles Schumer, D-NY) and the *Shareholder Empowerment Act of 2009* (Representative Gary Peters, D-MI) provide for directors at all listed US public companies to be elected by: — A majority vote in uncontested Board elections — A plurality vote in contested Board elections
- In May 2009, the SEC proposed a "proxy access" rule that would allow large shareholders to nominate director candidates directly in a company's proxy statement, eliminating the additional fees and documentation otherwise required for such shareholders to nominate director candidates by separate mailings. The SEC has said that the proposal requires further study and will not be in effect for the 2010 proxy season, but it is likely that some form of proxy access will be required in 2011.

Taken together, these reforms mean that more directors are more likely to lose election votes and Compensation Committee members may be particularly at risk. Already in 2009, nearly 10 percent of directors up for election had 20 percent of the shares voted against them or withheld, which is almost double the number from 2008. Approximately 60 percent of these directors were Compensation Committee members, and given the heightened scrutiny of executive compensation plans, such elections may prove more difficult than in past years.

2. What are the major legislative and regulatory drivers aimed directly at executive compensation that will affect executive compensation practices?

The primary legislative and regulatory initiatives directly impacting executive compensation practices include (a) additional proxy disclosure required by the proposed SEC rule changes, (b)

likely enactment of a mandatory "say on pay" vote for all public companies and (c) additional requirements for Compensation Committee independence.

Currently, "say on pay" and Compensation Committee independence are key provisions of legislation proposed by Representative Barney Frank, D-MA, as part of the *Corporate and Financial Institution Compensation Fairness Act of 2009* (CFICFA). A number of proposed bills currently under consideration in the House of Representatives and the Senate contain "say on pay" provisions as well as Compensation Committee independence requirements. CFICFA, approved by the House on July 31, 2009, is the leading bill.

3. What is the status and nature of the SEC's additional proxy disclosure requirements?

On July 10, 2009, the SEC published proposed rules that, if adopted, will significantly change public companies' required disclosures in their proxy statement and certain other filings. The SEC comment period on the proposed rules ended on September 15, 2009, and the proposed rules are expected to be finalized by early November and in effect for the 2010 proxy season. Companies should be studying the proposed rules now and preparing to act on the final rules as soon as they are adopted.

The proposed rules, among other things, would increase compensation practice disclosure to:

- require disclosure of the relationship between compensation policies and risk, for any employees involved in material risk taking activities (not limited to executive officers);
- change the manner in which stock and option awards are currently reported to require reporting of compensation for the entire award at the date of grant;
- require additional disclosure regarding director qualifications and Board leadership structure; and
- require information relating to compensation consultants' fees and services if consulting firm does work for company beyond advising the Board or Compensation Committee.

4. What do the SEC's proposed rules require regarding risk disclosure and what should companies be doing now to address these issues?

The SEC's proposed rules require companies to disclose their compensation polices for all employees where risks generated by those policies "may" be "material." Specifically:

- Companies will be required to discuss compensation arrangements that could create incentives for any employees to take on excessive amounts of risk.
- In a major break from the current rules, the rules pertaining to risk disclosure would specifically extend the requirement beyond executive officers.

- Disclosure of risks arising from compensation practices would be required if such risks “may have” a “material” impact on the company.

The proposed risk rules are highly controversial, appear to be aimed at financial firms, arguably fight the last war and are likely to be modified substantially in response to many comments received by the SEC.

Compensation Committees should begin to discuss enterprise risk issues with management, identify material risk areas and assess whether the compensation plans applying to employees involved in these areas may encourage the employees to take undue risks in order to maximize their compensation.

In analyzing these issues, Compensation Committees and management should review the general design philosophy of the compensation programs, the mix of compensation elements, the structure of performance goals, the use of holdbacks or escrows, clawbacks and equity holding period requirements, how adjustments are made or policies are changed based on changes in risk profiles and how compensation policies are monitored with respect to risk.

5. What is “say on pay” and what is its US history?

Although “say on pay” comes in many forms, it generally refers to a shareholder advisory vote on executive compensation policies, practices and/or pay for the “named executive officers” whose compensation is reported in a company’s proxy. Although such votes are non-binding and only advisory, “say on pay” provides shareholders with an opportunity to express satisfaction or dissatisfaction with companies’ executive compensation policies, practices and/or payments. How a company responds to a shareholder vote is likely to influence the outcome of their director elections, especially with respect to Compensation Committee members, and shareholder votes with respect to equity compensation plans.

“Say on pay” has been advocated by shareholder activists since 2006 via individual company proxy proposals requesting that companies permit “say on pay” votes by shareholders. This issue has gained substantial momentum over the years:

- In 2006, seven proposals were submitted by shareholders for shareholder vote.
- In 2007, 53 proposals were submitted by shareholders for shareholder vote.
- In 2008, 66 proposals were submitted by shareholders for shareholder vote.
- In each of these years, these proposals received approximately 40 percent favorable votes, on average.

As of October 1, 2009, results have been tracked for 71 companies for which “say on pay” proposals were submitted to shareholder vote in 2009. The “say on pay” proposals at these 71 companies received approximately 46 percent favorable votes, on average.

6. What is the likelihood of the enactment of a requirement that all public companies allow their shareholders to have a “say on pay”?

Very likely.

Momentum for required “say on pay” votes has been building since 2007, when the House passed the *Shareholder Vote on Executive Compensation Act* (Representative Barney Frank), which would have required companies to allow “say on pay” votes on compensation disclosed in their proxy statements. A companion bill, introduced in the Senate by then- Senator Barack Obama, died in the Senate.

In 2009, numerous bills pending in House and Senate committees include mandatory “say on pay” provisions, such as the *Investor Protection Act of 2009* (Treasury Department), the Shareholder Empowerment Act of 2009, the Shareholder Bill of Rights Act of 2009 as well as CFICFA, also proposed by Representative Barney Frank.

CFICFA is considered to be the front runner of the various bills under consideration, having been passed by the House on July 31, 2009. The key provisions of CFICFA as enacted by the House include:

- an annual non-binding vote on named executive officer compensation, based on the disclosure of such compensation in the proxy statement;
- a non-binding vote in proxies approving corporate transactions (not annually) on “golden parachutes” (very broadly defined) payable to named executive officers in connection with the transaction, no matter the amount of compensation; and
- requirements for Compensation Committee members to meet strict standards for independence.

As passed by the House, CFICFA would apply to annual meetings of public companies held six months after the date the final rules are issued, and the SEC would be required to issue final rules within six months of enactment. Thus, such rules would apply no later than 12 months from enactment.

CFICFA is currently awaiting action by the Senate, where the Senate Banking Committee may consolidate the “say on pay” and other provisions of CFICFA into a larger bill overhauling the

regulation of the financial services industry. Such a move would likely delay the enactment of a mandatory “say on pay” requirement for all public companies until 2011 or 2012.

7. What has been the outcome of shareholder votes on executive compensation?

In 2009, the American Recovery and Reinvestment Act of 2009 requires the more than 300 financial institutions participating in TARP to include a “say on pay” vote in proxy statements filed after February 17, 2009. To date in 2009, approximately 24 non-TARP companies, including Intel Corporation, Verizon Communications Inc., Motorola, Inc. and Blockbuster, Inc., have also conducted “say on pay” votes.

Results have been tracked for 127 companies whose shareholders voted on “say on pay” proposals. As of September 28, 2009, “say on pay” proposals at these 127 companies have received approximately 89 percent favorable shareholder votes. Most of these advisory votes have been held at TARP companies. These votes seem anomalously favorable and could be influenced by a number of factors, including the impact of broker voting of non-directed shares, the scaling back of financial sector compensation in 2008 and 2009 in reaction to the financial crisis and the relatively little time TARP shareholders were given to evaluate company plans. The 2010 results could differ.

8. To what extent did proxy advisory services, such as RiskMetrics Group (ISS), institutional shareholders and shareholder activists impact executive compensation policies in the 2009 proxy season?

Proxy advisory services, institutional shareholders and shareholder activists are more active than ever and have had greater influence on compensation policies, especially with respect to equity plans and director elections. As of September 28, 2009, 93 Board members at 50 companies received fewer than half the votes cast at annual meetings. This is more than twice as many as any other year since 2003, the year such information was first tracked.

For 2009, proxy advisors, such as RiskMetrics Group, recommended that shareholders vote against a record number of equity plans and directors on the basis of “poor pay practices,” such as golden parachute payment tax gross ups, tax reimbursements on perquisites, “single trigger” severance payments, overly generous perquisites (such as personal use of corporate aircraft or car allowances), “egregious” pension/ SERP payouts and payments upon an executive’s termination in connection with performance failure. In many cases, companies were forced to amend their pay practices, generally prospectively, in order to obtain the support of the proxy advisors, often requiring the amendment of outstanding proxies.

Institutional investors also played a bigger role in influencing executive compensation practices in 2009 than ever before. For example, it has been reported that Fidelity Investments voted against 55 percent of all executive compensation plans presented for vote, against 23 percent of directors seeking election (citing reasons such as the adoption of “golden parachute” pay plans, poor attendance at Board meetings and failure to follow through on promises to change compensation practices as key drivers of their vote) and against at least one management recommendation at half of the shareholder meetings at which the firm voted.

9. Given the growing influence of proxy advisors, institutional investors and shareholder activists, and the unprecedented level of legislative and regulatory developments aimed at executive compensation, what should companies be doing now to prepare for increased scrutiny of and added pressure on executive compensation plans and policies?

Although many of the legislative and regulatory changes are still in the “proposed” stage, companies should start preparing now for the increased scrutiny of and added pressure on their compensation practices and policies and Boards. Boards, Compensation Committees and/or company leadership should:

- Consider strategies to create a dialogue with important shareholders, such as through investor surveys or the use of technology to deliver information and exchange ideas.
- Spend time understanding the composition of the company’s shareholders, what issues are topof- mind for shareholders and how executive compensation programs can be modified and effectively communicated to shareholders in response.
- Consider doing away with “hot button” components of executive compensation packages, such as tax gross-ups and excessive executive perquisites.
- Allow for enough time to draft carefully persuasive proxy disclosure which both describes executive compensation practices as well as justifies the policies driving such practices.
- Continue monitoring legislative and regulatory developments to prepare for any material changes to proposed rules and regulations and to maximize preparation time once applicable rules go into effect.
- Consider triennial vote if considering adopting “say on pay” vote. A triennial vote was recently adopted by Microsoft for its 2009 meeting, which has much to recommend it.

10. How should companies and Compensation Committees use pay surveys and other market data this year?

Always limited by their “rear view mirror” perspective, surveys and past market data must be considered with extra care in a year such as this one. Two important aspects need special attention:

- For example, most current surveys reflect that the 2008 year was still strong for some sectors of the economy but weaker for others. 2009 will mostly be a weaker year so bonuses will generally be less than what surveys show to be competitive based on 2008 pay. Further, where surveys show target bonus levels for 2008 or even 2009, those structures may be suspended or modified for 2010. In other words, the business objectives being set for 2010 may be sufficiently below the acceptable range of "full performance" such that companies may suspend or reduce their target payout structures for 2010. Companies should take care to understand the performance context of the reporting companies to a survey or data set. This is obviously easier if it is a sector-focused survey than a general industry report. By example, the life sciences sector has had a strong year in 2009 relative to other sectors, such as semi-conductors. Perspective on market, quite possibly developed anecdotally (if not systematically), is important.
- 2008 data might include grants made by one reporting company in February of 2008 at relatively high share prices and from another reporting company in December when prices were markedly lower. Intuitively we know those December grants are more valuable than the February ones but the survey data will report otherwise. Again, developing perspective on the reporting companies is important. Companies that grant all or mostly full-value shares generally tried to stay "true" to target grant date dollar values. Nonetheless, share usage constraints may have caused them to reduce dollar values with the result that they still may have granted more shares than the prior year as a result of the steep drop in share price. Companies using options also tended to grant more of them but their grant date fair values probably dropped even further. Testing in many sectors shows that grant date fair values dropped in 2009 by 15-30 percent. Concurrently, the numbers of shares or options granted generally still went up. Further, while equity grants made in prior years are out-of-the-money or well below their grant values, many equity grants made in early 2009 have significant paper gains stemming from the broad recovery in equity markets over the course of the year.

Survey data should remain an important reference point to pay decision-making, but as always, it should remain just that and not be the predominant driver of pay actions. More than ever, research and investigation to build a context to understand the data is critical.

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