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SMITH ANDERSON

Client Alert

House Passes Corporate and Financial Institution Compensation Fairness Act of 2009

On July 31, 2009, the House of Representatives passed the Corporate and Financial Institution Compensation Fairness Act of 2009 (the "Frank Bill"), which was introduced by Representative Barney Frank and approved by the Financial Services Committee earlier in the week. Similar legislation focused on executive compensation reform has been introduced in the Senate by Senator Schumer and by the U.S. Treasury. The Frank Bill was passed along primarily partisan lines (237-185) and reports indicate that the Senate is not likely to consider similar legislation until after its August recess and it is expected to be a more contentious battle there. In terms of timing, despite pressure from the Obama administration to pass some form of "Say-on-Pay" and other executive compensation-focused legislation quickly, the legislation may be slow-moving. Set forth below is a summary of the material provisions of the Frank Bill.

Shareholder Vote on Executive Compensation Disclosures

Section 2 of the Frank Bill would require the Securities and Exchange Commission (the "SEC") to issue final rules applicable to public companies implementing an annual shareholder advisory vote on executive compensation as it appears in a company's proxy statement and on golden parachute compensation in connection with acquisitions, mergers, dispositions and proposed sales of companies. The SEC will have the authority to exempt certain public companies from this section of the Frank Bill, such as smaller reporting companies.

The effective date for this section of the Frank Bill would be six months after the SEC adopts the rules, and the SEC is directed to adopt the rules within six months of enactment of the Frank Bill into law. Therefore, it is unlikely that this will be a requirement for the 2010 proxy season. However, it should be noted that the U.S.

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Treasury recommended some type of Say-on-Pay requirement be in place for the 2010 proxy season, and Say-on-Pay legislation is considered a priority by the Obama administration, especially given President Obama's history as a Senator introducing legislation on the topic in 2007.

The Financial Services Committee version of the Frank Bill had included a provision prohibiting clawbacks of compensation arrangements that had been approved by shareholders. This provision was cut from the final Frank Bill as approved on July 31.

Compensation Committee Independence

Section 3 of the Frank Bill would require the SEC to direct the national securities exchanges and national securities associations to prohibit the listing of any class of equity of a public company that is not in compliance with certain requirements designed to enhance the independence of compensation committees. The SEC's rules are required to be effective not later than nine months after the enactment of the Frank Bill into law. Again, the SEC will have the authority to exempt certain public companies from the requirements of Section 3.

The requirements generally are that:

- Compensation committees be made up of independent directors.
- Compensation consultants satisfy independence criteria established by the SEC and the standards must be "competitively neutral."
- Companies must provide funding for compensation consultants if the compensation committee requires compensation consultation.

The originally introduced version of the Frank Bill included two provisions that were struck in the final Frank Bill. First, the final Frank Bill no longer requires a public company to disclose why a compensation committee didn't hire a consultant if it did not. Second, the final Frank Bill did not include the proposal to require that a compensation committee's legal counsel also meet certain independence standards.

Enhanced Compensation Structure Reporting to Reduce Perverse Incentives

Section 4 of the Frank Bill applies only to "financial institutions" with more than $1 billion in assets, specifically including banks, bank holding companies, broker-dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac. The Frank Bill would require the "appropriate Federal regulators" to:

- Prescribe regulations requiring such financial institutions to disclose compensation structures that include any incentive-based elements for executives and employees and then have the regulators determine if the compensation is "aligned with sound risk management."
- Prohibit "certain compensation" structures if the regulators deem that they could have a "serious adverse effect on financial stability."

The “appropriate Federal regulators” include the Federal Reserve Bank, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, National Credit Union Administration Board, Securities & Exchange Commission, and Federal Housing Finance Agency.

This section of the Frank Bill remains quite controversial with White House press secretary Robert Gibbs commenting that the provisions may give regulators too much authority over incentive pay. In addition, this section of the Frank Bill poses legal questions as to the government’s authority to nullify private contractual arrangements.

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While every effort has been made to ensure the accuracy of this memorandum, it is not intended to provide legal advice as individual situations will differ and should be discussed with an expert and/or lawyer. For specific technical or legal advice on the information provided and related topics, please contact Gerald Roach at 919.821.6668, Amy Batten at 919.821.6677, or Margaret Rosenfeld at 919.821.6714.

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