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SMITH ANDERSON

Client Alert

Recent Executive Compensation and Corporate Governance Initiatives Impacting Public Companies

On June 10, 2009, the Treasury Department and the Securities and Exchange Commission each advanced a number of initiatives relating to executive compensation and corporate governance. In addition, legislation was introduced in the U.S. Senate last month by Sen. Charles Schumer (D-NY) and in the U.S. House of Representatives on June 12, 2009 by Rep. Gary Peters (D-Mich.) seeking to expand the rights of shareholders of public companies.

While it is unclear precisely which of these initiatives will be enacted, it is clear that shareholders, regulators, and legislators will continue to focus on executive compensation and corporate governance. At a minimum, we expect that public companies will be required to provide shareholders with additional disclosures regarding executive compensation and corporate governance, a nonbinding vote on executive compensation, and enhanced access to their proxy statements in director elections.

At this juncture, we do not recommend that public companies take any drastic steps in response to these initiatives. Instead, public companies should take measured steps to continue to adhere to best practices in the areas of executive compensation and corporate governance. In particular, we recommend that (i) compensation committees consider Secretary Geithner's five principles discussed below when they set executive compensation, (ii) compensation committees and boards assess whether they have any potential conflicts with their compensation consultants, (iii) companies and their boards reassess how they manage

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risk, and (iv) nominating committees carefully evaluate the experience and qualifications of director nominees. Taking these steps now may help prevent embarrassing disclosures later.

Treasury Department Executive Compensation Initiatives

On June 10, 2009, Treasury Secretary Timothy Geithner stated that companies should adopt compensation practices that reward long-term value creation and do not encourage unnecessary risk-taking. In doing so, Secretary Geithner articulated the following five broad-based principles with respect to executive compensation:

- Compensation plans should properly measure and reward performance.
- Compensation should be structured to account for the time horizon of risks.
- Compensation practices should be aligned with sound risk management.
- Golden parachutes and supplemental retirement packages should be reexamined.
- The process of setting executive compensation should be transparent, and directors should be accountable to shareholders in setting such compensation.

While Secretary Geithner's five principles are not laws or regulations that public companies must follow, it is expected that prudent compensation committees of public companies will consider them in evaluating compensation for executives.

Secretary Geithner also announced the Obama Administration's support for "say-on-pay" legislation and legislation enhancing the independence requirements for compensation committees.

Say on Pay

The Obama Administration supports say-on-pay legislation that would require all public companies (not just listed companies) to give shareholders an annual, nonbinding vote on each of the following aspects of executive compensation discussed in their proxy statements:

- executive compensation (including the Compensation Discussion and Analysis and the compensation tables);
- compensation of the company's top five named executive officers;
- other compensation decisions at the discretion of the company (but the company must permit shareholders to vote on a resolution addressing all of the compensation disclosed in the proxy statement); and
- golden parachute compensation (in proxy statements relating to a merger, acquisition, or other transaction).

Public financial institutions that accepted TARP money were already required to present a non-binding say-on-pay vote to shareholders for the 2009 proxy season. As proxy votes are reported, it will be interesting to see whether the actual results are a rejection of compensation practices by such companies and, if rejection votes occurred, how the boards of such companies react.

Compensation Committee Independence

Secretary Geithner also announced that the Obama Administration would be proposing legislation that would make the compensation committees of listed companies more independent. This legislation would require the SEC to direct the national securities exchanges to impose the following requirements on listed companies:

- Compensation committee members must meet independence standards similar to those of audit committee members.
- Compensation committees would have additional powers with respect to compensation consultants, legal counsel, and other advisors.
- Compensation consultants and legal counsel would be required to meet new independence standards.

SEC Executive Compensation and Corporate Governance Initiatives

Also on June 10, 2009, SEC Chairwoman Mary Schapiro outlined key rulemaking proposals that the SEC is considering relating to executive compensation and corporate governance disclosure. These proposals would require greater disclosure about:

- how a company and its board manage risk;
- a company's overall compensation approach;
- potential conflicts between compensation consultants and the companies they advise; and
- director nominees, including their experience and qualifications, and why a company has chosen the leadership structure it has.

Later that day, the SEC issued its shareholder access release. In the release, the SEC proposes to amend the proxy rules to allow certain shareholders (including groups of affiliated shareholders) to include their director nominees in the company's proxy materials, subject to the following requirements:

- *Ownership requirements*. The shareholder would be required to own a certain percentage (1% for large accelerated filers, 3% for accelerated filers, and 5% for nonaccelerated filers) of the company's stock for at least one year, declare its intent to hold the stock through the annual meeting, and certify that it is not holding the stock to change the control of the company.
- *Nominee requirements*. The shareholder nominee's candidacy or (if elected) board membership would not be allowed to violate applicable laws or regulations, the shareholder could not have an agreement with the company regarding the nomination, and the nominee would be required to satisfy the objective independence standards of the applicable national securities exchange or national securities association (if any).
- *Maximum number of nominees*. A company would only be required to include the greater of one shareholder nominee or shareholder nominees totaling 25% of the company's board of directors. If more than one shareholder wishes to include nominees in the company's proxy materials, priority would go to the first shareholder to timely notify the company of its intention to do so.
- *Disclosure requirements*. The nominating shareholder would be required to file a Schedule 14N (a newly created form) with the SEC and submit a copy to the company. The Schedule 14N would include information regarding the nominating shareholder and the nominees.

In addition, the proposal would also amend SEC Rule 14a-8 (the existing shareholder proposal rule) to allow certain shareholders to include a proposal in the company's proxy materials to amend the company's nomination procedures or other director nomination disclosure provisions. A shareholder that has held the lesser of $2,000 or 1% of the company's stock for at least one year would be eligible to have such a proposal included.

Shareholder Empowerment Act and Shareholder Bill of Rights

The Shareholder Empowerment Act of 2009 introduced by Representative Peters and the Shareholder Bill of Rights Act of 2009 introduced by Senator Schumer cover much of the same ground as the Treasury's and the SEC's initiatives. Taken together, these Acts would require the following:

- *Majority voting (only listed companies).* In an uncontested election, each director would be required to receive a majority of the votes cast with respect to his or her nomination.
- *Shareholder access (for all public companies).* The SEC would be required to promulgate shareholder access rules. However, such rules could only apply to shareholders (or shareholder groups) that held at least 1% of the company's voting securities for at least two years.
- *Broker Discretionary Voting in Uncontested Elections (for all public companies).* Brokers would not be allowed to vote securities in an uncontested election unless the beneficial owner has provided specific instructions.
- *Independent board chair (only for listed companies).* The chairperson of the board would be required to be independent and have not previously served as an executive officer of the company. The Shareholder Empowerment Act provides for specific independence criteria beyond those promulgated by the SEC and the applicable securities exchange.
- *Say-on-pay vote (for all public companies).* Public companies would be required to include a nonbinding say-on-pay vote on executive compensation and (in proxy solicitations concerning a merger, acquisition, consolidation, or sale of all or substantially all of the company's assets) on golden parachute compensation.
- *Independent Compensation Advisors (for all public companies):* If a board or committee retains an advisor in connection with negotiating employment contracts or compensation agreements with the company's executives, the advisor would be required to be independent (as defined in the Shareholder Empowerment Act) and report solely to the board or committee. In addition, the company would not be permitted to indemnify the advisor or limit its liability.
- *Clawbacks of Unearned Performance Pay (only for listed companies).* Companies would be required to adopt policies providing for the recovery or cancellation of unearned bonus, incentive, and equity payments awarded to executive officers as a result of fraud, financial results that require restatement, or some other cause.
- *No Severance for Poor Performance (only for listed companies).* Companies would not be allowed to enter into agreements with executives under which executives would receive severance if terminated for poor performance. Any new agreements containing "for cause" termination provisions must include poor performance as a cause.
- *Improved Disclosure of Compensation Targets (for all public companies).* Public companies would be required to make additional disclosure of the specific performance targets they use to determine senior executive officers' eligibility for bonuses, equity, and incentive compensation.

- *No classified (or staggered) boards (only for listed companies).* Each director would be required to be subject to annual election by the company's shareholders.
- *Risk committee (only for listed companies).* Companies would be required to establish a risk committee, comprised entirely of independent directors, which would be responsible for the company's risk management practices.

Conclusion

Although passage of each of the above initiatives is unlikely, we expect that Congress will pass (in some form) say-on-pay legislation, the SEC will adopt a shareholder access rule, and there will be increased scrutiny on (and more disclosure required about) executive compensation, corporate governance, and corporate risk management. Less certain is whether the Obama Administration's proposed compensation committee independence legislation (which Barney Frank (D-Mass.), the Chairman of the House Financial Services Committee, has stated would be ineffective), the Shareholder Empowerment Act, or the Shareholder Bill of Rights Act will be enacted. In particular, the legislative proposals requiring a majority vote for directors and eliminating classified boards would represent an unprecedented federalization of U.S. corporate law and will likely encounter significant opposition.

Although it is unclear precisely which of the above initiatives will be enacted, what is clear is that the increased focus on executive compensation and corporate governance by shareholders, regulators, and legislators is here to stay.

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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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