EXECUTIVE COMPENSATION GOVERNANCE REFORMS

How Legislative Proposals Stack Up

Comparing the House and Senate versions with recent SEC regulation and proxy advisor guidance

With the Senate's May 20, 2010, passage of executive compensation and corporate governance reform legislation, two separate but similar bills are in front of Congress. Reconciliation of these bills is expected this summer, perhaps as early as July. Assuming passage of some form of combined act, companies will be facing further changes to their governance and pay processes and policies, in addition to the changes they have had to make since the SEC revisions of last December. This Alert compares the two pieces of legislation, and shares Radford's observation on the impact the reforms could have on companies.

The arrival of the proposed legislation on the heels of the recent SEC actions is likely to create some confusion for companies trying to reconcile and compare the various rules. As such, this alert also discusses, where relevant, how the legislation stacks up against current SEC, proxy advisor and exchange guidance and regulation.

Say-on-Pay

The House and Senate versions of say-on-pay legislation are similar; both compel companies to hold non-binding votes on executive compensation. The two differ mostly in this respect: the House version requires the vote at an annual meeting to elect directors and would be in force six months following SEC implementation of the rules, whereas the Senate version applies to any shareholder meeting occurring six months *after* the bill is enacted. (Note: very small companies – those with less than $75 million in common equity – are exempted from the House version; this exception is broadly applied throughout the proposed legislation).

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What is clear from the proposed legislation, say-on-pay voting patterns, shifting proxy advisor guidelines, and the tenor of public discourse on the subject is that the definition of 'nonbinding,' has altered perceptibly. The broader shift at play is one that both nudges greater activism on the part of shareholder groups, and greater adherence to the wishes of shareholders on the part of companies. Companies are not, under the legislation, compelled to follow the votes of shareholders on executive compensation, but those that do not will invite a negative reaction from RiskMetrics and other advisors (in the form of director Withhold or No vote recommendations in the year after the say-on-pay vote). Further, as we have seen with recent votes at Motorola and Occidental Petroleum, companies have no guarantee that they will win these votes, regardless of how the proposals are worded.

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The voting process suggests that clients need to look at not simply *reporting* their compensation programs, but also *marketing* those programs to their shareholders. Companies should view their Compensation Discussion and Analysis (CD&A) as a means of selling the underlying rationale and philosophy of their executive compensation programs, to ensure that shareholders understand and support them.

The Senate version of the legislation, if passed, will require relevant process changes for the 2011 proxy season; the House version could take up to one year to enact. In either case, say-on-pay has its own momentum independent of this legislation, and companies should consider their course of action accordingly.

Clawbacks

The Senate version of the bill requires the exchanges to stipulate a clawback policy as condition of listing. The bill would require recovery of incentive compensation paid to any executive officer (not just the CEO and CFO, as is currently the rule) in a three-year period following a restatement of financials. Clawbacks would be predicated on the restatement alone, apply only to the difference in what should have been awarded as implied by the restated financials, and would be in force irrespective of any misconduct on the part of executives.

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Some commentators have noted that because these provisions are in one, but not the other, version of the proposed legislation, passage perhaps does not have the required level of support. Whether as a standalone component of enacted legislation or not, these issues are front-of-mind for shareholders and proxy advisors, and are evaluated as part of shareholders' overall views of executive compensation practices and corporate governance policies. As a matter of good governance, companies should evaluate their clawback and change-in-control agreement provisions against already-established standards to ensure that they operate in the best interests of shareholders, and not rely solely on the competitive marketplace as a rationale for non-shareholder-friendly contracts.

Pay-Vs-Performance

Regulators, advisors and law makers have struggled over the past several years to find a way to inform shareholders about how executive compensation is linked to (or disconnected from) company performance. The SEC had, and then eliminated in 2006, a requirement to include a Stock Performance Graph in proxies, which ostensibly illuminated the link. The Senate bill would likely mean the return of this type of disclosure, or at least disclosure that would clearly show the relationship between pay and company performance (including stock price movement, dividends and other distributions).

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Companies have sought to link pay and performance for years. The issue has always been the definition of "performance" – is it simply stock price appreciation, or are there other more applicable measures? Because companies already go to lengths in CD&As and through other means to demonstrate this link, they will need to wait to see exactly how (or if) any specific changes that follow new legislation will need to be handled, and how that will be different from existing proxy advisory guidelines.

Director Independence

The Senate and House bills differ on how to define and establish the independence of compensation committee members, but both would require it. The Senate bill is more concrete in its description of independence, which is akin to standards for the Audit Committee: members could not be compensated by the company for anything aside from board membership. Subsidiaries, and affiliates of the subsidiaries, would be included in the definition of "company," which would make the provisions of this bill distinct from existing NYSE and NASDAQ rules.

The House bill is similar to the Senate's, except that it would call for the exchanges to define independence, and thus the exchanges would have the authority to allow certain relationships they deemed acceptable.

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The objective in both versions of the bill is the same: tighten the current definitions for director independence.

Compensation Advisors

Both bills address the issue of advisor independence, but they do so in different ways. The House bill would require companies to provide the funding and authority required by the Compensation Committee to secure advisory services on issues related to pay. It would also require that advisors meet standards of independence as defined by the SEC.

The Senate bill would not require board committees to hire only advisors without conflicts, but would rather require committees to consider the factors used by SEC to establish its advisor independence guidelines in making an advisor determination. (Such factors include the percentage of total revenue represented by the fees; the value of other services provided by the advisor, if any; and the advisor's policies with respect to conflict or potential conflict.)

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Both versions seek to mitigate *perceived* conflict of interest on the part of advisors that support Compensation Committees. The Senate version is more closely aligned to SEC and advisor guidelines in that it allows committees greater latitude in viewing potential conflicts as one (among many) factors to consider when choosing the most appropriate advisor. We would suggest that boards and companies are best served when the committee has the greatest degree of freedom in choosing its advisors from among the most qualified in terms of experience, industry expertise, technical depth, etc.

Other Provisions of the Senate Bill

The Senate bill would require companies to disclose the rationale for their board structure, specifically why they have the same person (or different people) occupying the CEO and Chairman roles. A similar SEC rule already exists.

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Many technology and life sciences companies have already made the shift to separating the CEO and Chairman roles, and we believe this trend is likely to continue. Those companies that maintain a strong rationale should be prepared to fully articulate that rationale, whether as part of a legal requirement or simply as a matter of sound shareholder communication practices.

The Senate bill would also require companies to adopt a majority vote rule with respect to uncontested direct elections. The rule would call for the resignation of any director receiving less than a majority of votes, or for a unanimous board vote against the resignation along with disclosure of the rationale for their vote.

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With or without this legislation, boards will want to move cautiously in overturning the outcome of a vote where a director does not receive a majority of votes.

Finally, the Senate bill contains a provision that requires brokers receive voting instructions from beneficial owners before voting shares in elections and on say-on-pay provisions. It also would apply to any executive compensation issue, and as such, could be construed as relevant in cases where employee stock plans are up for approval.

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Legislators are attempting to ensure that shareholder interests are not circumnavigated by brokers who control large blocks of shares, a move very much in keeping with the spirit of reforms from the SEC, proxy advisor, exchanges and other quarters.

Conclusion

While the House and Senate bills now up for reconciliation and approval represent perhaps a forceful legislative attempt at reform, many of the provisions within them have currently enacted analogs, whether from the SEC, the exchanges or proxy advisors. Irrespective of the outcome, reformers seem intent to continue to rein in the avenues of perceived excess, pay-for-performance disconnect and inadequate governance. As such, companies will want to continue to ensure that pay policies/programs and governance standards are marketed, and defended, to shareholders.

More Information

We encourage you to forward this Alert to your board members. And as always, we encourage you to contact us if you have questions. For more information, contact:

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