Congress Pushes Forward Executive Compensation Regulation and Say on Pay Legislation

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August 18, 2009

Continuing the push towards greater federal regulation of executive compensation, the House of Representatives approved H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009, on July 31, 2009. Following and expanding upon President Obama's white paper on Financial Regulatory Reform announced in June, H.R. 3269, introduced by Representative Barney Frank, the chairman of the House Financial Services Committee, would do the following:

- Shareholders of public companies would have the right to "say on pay," whereby the shareholders would have the right to a separate non-binding vote to approve the compensation packages for the "top 5" executives, including any golden parachutes;
- Public companies traded on any U.S. stock exchange would be required to have a compensation committee composed of independent directors, and the compensation committee would have the authority (including funding authority) to hire outside consultants and attorneys to evaluate such company's compensation programs (this legislation is modeled on the requirements for independent audit committees contained in the Sarbanes-Oxley Act of 2002); and
- Applicable federal regulators, including the SEC and the Federal Reserve, would have the authority to prohibit incentive compensation packages offered by "covered financial institutions" with assets of $1 billion or more that encourage their employees to take "inappropriate risks" that (i) threaten the "safety and soundness" of covered financial institutions or (ii) could have serious adverse effects on economic conditions or financial stability.

The swift passage of H.R. 3269, as well as legislation passed in March relating to AIG bonuses, serves as a reminder that the public uproar over executive compensation has not abated, and that additional regulation is forthcoming. Some key decisions to look for include the following:

- *Will Regulation of Executive Compensation Include Pay Caps?* The federal government has traditionally regulated executive compensation through the tax code and the disclosure requirements of the securities laws. In the past few years, the SEC required public companies to expand their discussion of executive compensation in the "CD&A" section of the proxy statement, and, in the past few months, the SEC has proposed new requirements for CD&A. "Say on Pay" imposes greater scrutiny of compensation decisions but nevertheless does not set pay standards. President Obama's Financial Regulatory Overhaul proposal, which included similar provisions for "say on pay" and compensation committees, also introduced a set of principles that companies should adhere to in setting their compensation packages. Even this proposal, however, did not impose pay caps—except in the case of TARP recipients[1]. Nevertheless, the approval of H.R. 3269 shows that the zeal to restrict incentive compensation packages is strong, and the President and Congress will struggle with the tension between transparency and control as it moves forward to address executive compensation.
- *What Institutions Will Be Affected?* Various institutions and industries will be affected by the collective push to regulate executive compensation. Public companies will be subject to new disclosure and proxy access requirements, and, if enacted, "Say on Pay"; although H.R. 3269 grants the SEC the authority to exempt smaller reporting companies. The incentive compensation restrictions contained in H.R. 3269 apply to all "covered financial institutions" with assets of $1 billion or more. Covered financial institutions include banks, credit unions, broker-dealers and investment advisers. Under this legislation, a large hedge fund manager, even if not required to be registered as an "investment adviser," could be subject to explicit restrictions on its incentive compensation programs such as the payment of certain "points" of carried interest to its employees.

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- *Will It Pass?* Most observers expect that Congress will approve and President Obama will sign “Say on Pay.” It remains unclear, however, whether this legislation will move separately—as it did in the House—or will be tied to a larger financial regulatory overhaul. Congress expects to take up such larger legislation later this year, but the likelihood and timing of approval remains uncertain. Most observers also do not expect that the pay restrictions contained in H.R. 3269 will become law. In fact, Treasury Secretary Geithner’s statement on H.R. 3269 praised the passage of “Say on Pay” and compensation committee legislation, but his statement was noticeably silent on the rest of the legislation. At the very least, the passage of “Say on Pay” in the House shows the continued momentum for this legislation and further regulation of executive pay.

In response to the current economic downturn and the evolving governmental approach to abate its effects, Andrews Kurth formed its Economic Recovery and Government Opportunities Task Force (ERGO). ERGO is a cross-disciplinary effort designed to assist our clients in three broad areas related to economic recovery:

- The Financial Stability Plan, including Government initiatives such as TALF and PPIP that are intended to re-establish viable markets and create opportunities for the business and investment community,
- Recovery Act/Stimulus Appropriations, including the 2009 American Recovery and Reinvestment Act, and
- Financial Regulatory matters, including prospective changes to the regulatory framework of financial institutions and financial intermediaries, and the reallocation of enforcement authority among federal and/or state authorities.

Andrews Kurth remains committed to keeping the business community informed about these developments and potential opportunities. Should you have any questions about these matters, please contact G. Michael O'Leary, Peter Bogdanow or your Andrews Kurth contact.

[1.] *Certain TARP recipients are subject to explicit restrictions on the payment of bonuses and are also required to submit their pay packages for certain executives to a compensation czar for approval.*