

## Legal Updates & News

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## Administration Proposals on Compensation Committees and Say on Pay Would Affect All Public Companies

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On July 16, 2009, as a part an effort to move the Obama Administration's regulatory reform agenda forward, the Treasury Department delivered draft legislation to Congress that would require enhanced compensation committee independence for listed public companies, as well as advisory votes on executive compensation.

The draft legislation, if ultimately introduced and enacted, would require the Securities and Exchange Commission (the "SEC") to promulgate rules directing the national securities exchanges to adopt strict standards for the independence of compensation committee members. These rules also would require that compensation committees have authority and funding to retain consultants and counsel, and that such consultants and counsel also be independent from management. These rules would closely track the requirements for audit committees adopted as part of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").

In addition, the proposed legislation would mandate that all public companies soliciting proxies or consents for an annual meeting occurring after December 15, 2009 must provide for a separate advisory shareholder vote on the compensation of executives as disclosed under the SEC's proxy rules. Further, the legislation would require additional disclosure and a non-binding vote on any compensatory arrangements of executive officers relating to certain extraordinary corporate transactions whenever proxies or consents are solicited in connection with such a transaction.

### Compensation Committee Independence and Advice

The proposed legislation would take three key steps that the Administration believes are necessary to ensure that compensation committees have the independence and expert assistance they need to serve their role.

First, the proposed legislation would require that compensation committee members meet stricter standards for independence from management that are similar to the independence standards currently

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applicable to audit committee members under Sarbanes-Oxley. In particular, the rules would prohibit compensation committee members from accepting consulting, advisory, or other compensatory fees (other than in their capacity as members of the board of directors, the compensation committee, or any other board committee), and would require that compensation committee members not be affiliated with the company or any of its subsidiaries. As with audit committees, these enhanced independence requirements would apply to all members of the compensation committee. These requirements would be in addition to current independence standards. While stock exchanges have set their own such standards, the Administration believes that these standards may not go far enough to ensure that shareholder interests are protected. One example noted in the Treasury Department's press release announcing the proposal points out that, under New York Stock Exchange listing standards, directors can still be considered independent even if they receive up to \$100,000 in outside compensation from the company – in addition to directors' fees; and a director who owns or operates a business receiving up to \$1 million in revenue from the company might still be determined to be independent.

Second, the legislation would direct the SEC to require exchange listing standards that require compensation committees to have the authority and funding to hire independent compensation consultants, outside counsel, and other advisers. This is similar to the authority that Sarbanes-Oxley mandated for audit committees. The Administration believes that, under current requirements, compensation committees may negotiate pay at a significant disadvantage to management, because executives use compensation consultants to advocate for their views, while the committee may not have access to experts of its own. It is the Administration's belief that providing compensation committees with access to independent consultants can "level the playing field." The proposed legislation also would require that the SEC direct the exchanges to adopt standards making compensation committees directly responsible for the appointment, compensation, retention, and oversight of the work of any compensation consultants that they retain, and require such compensation consultants to report directly to the compensation committee. In addition, the proposed legislation would require that any proxy statement or consent solicitation statement for a public company's annual meeting (or special meeting in lieu thereof) disclose whether the compensation committee retained a compensation consultant satisfying the required standards of independence and, if such a compensation consultant was not retained, the basis for the compensation committee's determination not to do so.

Finally, to ensure that compensation committees are receiving objective advice, the proposed legislation would require the SEC to adopt standards for the independence of compensation consultants and outside counsel hired by compensation committees.<sup>[1]</sup> In support of this proposed requirement, the Administration cites studies suggesting that the use of consultants with conflicts of interest may lead to an increase in the compensation paid to top managers.

### **Advisory Vote on Executive Compensation and Golden Parachutes**

The proposed legislation also seeks to mandate a "say on pay" proposal for all public companies soliciting proxies or consents at an annual meeting (or special meeting in lieu of an annual meeting). Under the proposal, companies would be required to provide a separate shareholder vote to approve the compensation of executives as disclosed under the SEC's compensation disclosure rules (including the Compensation Discussion & Analysis, the compensation tables, the Compensation Committee Report, and related materials). This vote to approve executive compensation would be deemed non-binding on the board and would not be construed as overriding any board decision. Further, the vote to approve executive compensation would not create or imply any additional fiduciary duty of the board. The shareholder vote would not prevent shareholders from continuing to make shareholder proposals with regard to executive compensation. The draft legislation contemplates implementation of say on pay for meetings occurring after December 15, 2009.

Similar to a bill that President Obama had introduced while serving in the Senate, the draft legislation proposed by the Treasury also contemplates a separate vote to approve so-called "golden parachute" payments in the event of an extraordinary transaction. As with the say on pay proposal, this vote would be non-binding and would not be construed as overruling a decision of the board, nor would it create or imply any additional fiduciary duty, nor would it restrict or limit the ability of shareholders to make proposals for inclusion in the proxy statement. Unlike the say on pay proposal, this vote would only be required whenever proxies or consents are solicited in connection with an acquisition, merger, consolidation, sale, or disposition of all or substantially all of the assets of an issuer. For purposes of the proposed legislation, the term "golden parachute" is not defined; rather the legislation would provide that

“any agreements or understandings” that the soliciting person has with the executive officers of a company (or the acquiring company, as applicable) concerning “any type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the [transaction]” must be subject to shareholder approval.

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This proposed legislation is part of the Administration’s “Investor Protection Act of 2009” and is the second piece of draft legislation released by the Administration to implement portions of the financial regulatory reform proposals contained in its recent White Paper.<sup>[2]</sup> Various similar legislative initiatives are underway in Congress.<sup>[3]</sup> We will continue to monitor the status of key elements of the reform proposals and provide alerts as the legislative and regulatory process develops.

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#### Footnotes

[1] In a separate action, the SEC recently proposed enhanced disclosure about the use of compensation consultants, including in certain circumstances the amount of aggregate fees paid to such consultants. See “[SEC Proposes Rules to Enhance Compensation and Corporate Governance Disclosures.](#)”

[2] See “[Newton’s Third Law and the White Paper.](#)”

[3] For example, Representative Peters (D-MI) recently introduced the “Shareholder Empowerment Act” in the House and Senators Schumer (D-NY) and Cantwell (D-WA) recently introduced the “Shareholder Bill of Rights Act” in the Senate. For more on the Shareholder Bill of Rights Act, see “[Far-Reaching Shareholder Bill of Rights Introduced in the Senate.](#)”