



2010 Proxy Season – SEC Enhanced Disclosure Requirements; Executive Compensation Developments

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Introduction

What has led to the current legislative and regulatory reform environment?

- Perception that executive compensation contributed to the financial crisis
- Financial institutions took excessive risk and executives at financial institutions were incentivized to take risk
- Politically charged issue that is not going away
 - bonus plans and expected payouts reported by Goldman Sachs, JP Morgan and Bank of America, among others, have renewed the public's outrage
 - large financial institutions are trying to address, including as a public relations crisis (e.g., Goldman Sachs requiring partner charitable donations)
 - British tax on banker bonuses and mandatory deferral of large percentage of compensation
- Compensation reforms are linked to governance reforms
 - SEC believes that by holding directors more accountable through the election process coupled with enhanced compensation disclosures will promote more responsible compensation practices
- Expect increase in proliferation of (i) shareholder derivative lawsuits claiming director breach of fiduciary duty and waste and (ii) shareholder proposals seeking changes in compensation programs where companies have not adopted “best practices”
 - popular shareholder proposals include pay for performance, stock retention, clawbacks and imposing limitations on severance pay
- With other legislative and SEC reforms providing for say-on-pay and shareholder access, also expect:
 - boards to increasingly have dialogue with large shareholders on compensation matters

Director Duties and Litigation over Executive Compensation

Directors are subject to claims of breach of fiduciary duty and corporate waste in connection with compensation decisions

Claims for breach of fiduciary duty may be based either on (i) breach of the duty of due care or (ii) breach of the duty of good faith*

- To prevail on a claim that a director has breached the director's duty of due care, a plaintiff must establish that the director acted with gross negligence
- To prevail on a claim that a director breached the director's duty of good faith, a plaintiff must establish that the director acted in bad faith
 - bad faith is an *intentional dereliction of duty* ... consciously and intentionally disregarding one's responsibilities
 - difficult to establish as requires proof of a subjective bad motive or intent
 - gross negligence, by itself, does not constitute a breach of the fiduciary duty of good faith
- Whether a director has breached these fiduciary duties is determined on a "director by director" basis rather than the Board as a collective unit
- Because companies' charter provisions typically provide exculpation for liability based on breach of the duty of due care, claims alleging breach of the duty of good faith are common
 - directors face potential personal liability if they violate their duty of good faith

In addition to claims for breach of fiduciary duty, claims also may be based on corporate waste

* Claims for breach of fiduciary duty also may be based on breach of loyalty, but such a claim would need to establish that a director acted to advance the director's interests. This discussion is based on Delaware law.

Director Duties and Litigation over Executive Compensation (cont'd)

- To establish waste, plaintiffs must establish that a transaction is "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."
- In the Disney case involving the termination of and severance payments to Michael Ovitz, the Delaware Supreme Court stated that a claim of waste will only arise in the rare 'unconscionable case where directors irrationally squander or give away corporate assets.'
- Nevertheless, courts have cautioned that "there is an outer limit" to the board's discretion to set executive compensation
 - in the recent Citigroup derivative lawsuit, the Delaware Chancery Court did not dismiss a claim of waste relating to Citigroup's severance agreement with former CEO Charles Prince

In addition to civil litigation, companies also face potential SEC enforcement actions if disclosures relating to executive compensation are not fair and accurate, including claims that a company's disclosure controls are inadequate

Process for decisions relating to executive compensation should meet "best practices" particularly given the heightened scrutiny concerning executive compensation matters

- Independent compensation consultant
- Relevant materials and analysis furnished to directors

Director Duties and Litigation over Executive Compensation (cont'd)

- Directors should review and understand executive compensation arrangements, including potential outcomes under different scenarios
- Risk analysis
- If appropriate, independent counsel
- Fair and accurate disclosure

SEC Rules for Expanded Compensation and Corporate Governance Disclosures*

SEC Proxy Disclosure Enhancements

- Adopted December 16, 2009
- Effective February 28, 2010
 - if the company's fiscal year ends on or after December 20, 2009, its Form 10-K and proxy statement must be in compliance with the new proxy disclosure requirements if filed on or after February 28, 2010
 - if the company files a preliminary proxy statement before February 28, 2010 but expects to file its definitive proxy statement on or after February 28, 2010, then its preliminary proxy statement must be in compliance with the new disclosure requirements
- Driven by 2008 economic crisis and view of regulators that (i) greater transparency with regard to the link between risk taking and compensation is required and (ii) enhanced compensation and governance disclosures will enable greater accountability of directors to shareholders for compensation decisions and risk oversight
- Need to provide additional disclosures likely to result in companies modifying their compensation and governance processes

* In addition to these proposals, the SEC has proposed rules to provide for proxy access (i.e., inclusion of shareholder nominees in a company's proxy statement) and inclusion of shareholder proposals relating to director nominations. On December 14, 2009, the SEC re-opened the comment period on the proposed rules, and Commission action is not expected until late in the first quarter of 2010.

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

SEC Proxy Disclosure Enhancements (cont'd)

- New rules provide for expanded disclosures about risk, compensation and corporate governance matters
 - compensation policies and impact on risk taking
 - method for reporting stock and option awards of executives and directors
 - director and nominee qualifications and legal proceedings; diversity
 - Board leadership structure
 - the Board's role in the risk oversight process
 - potential conflicts of interest of compensation consultants
- The SEC also has accelerated the timing for the disclosure of voting results of shareholder meetings, which now will be required to be reported promptly (i.e., within 4 business days) on Form 8-K

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

SEC Proxy Disclosure Enhancements (cont'd)

- The SEC **did not** take action on various additional disclosures on which it requested comment in its proposing release, including:
 - compensation disclosure for all executive officers, not just the Named Executive Officers
 - requiring disclosure of confidential performance targets
 - requiring that the Compensation Discussion and Analysis (CD&A) be made a part of the Compensation Committee Report and considered to be “filed” rather than “furnished”
 - disclosing whether a member of the Compensation Committee has expertise in compensation matters
 - disclosures about clawback policies or “hold til retirement” policies
 - disclosures about internal pay policies

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Disclosure

- New Item 402(s) of Regulation S-K requires disclosure in cases where the company's compensation policies create risks that are reasonably likely to have a material adverse effect on the company
- Although the new disclosure rule is not limited to incentive compensation arrangements, the key purpose of the new rule is to elicit disclosure where an incentive compensation arrangement may incentivize management or other employees to take risks or other actions to maximize short-term results, without regard to long-term considerations
- As Compensation Committees undertake a risk assessment of their compensation policies, they may modify or adopt new practices, such as longer vesting or holding periods, clawbacks, changing the mix of performance criteria and changing the allocation between annual and long-term incentive awards
- Disclosure is required for policies or practices relating not only to executives, but also to any employees
 - the proposing release refers to the FSF Principles of Sound Compensation Practices, which notes that non-executive employees may have a heightened incentive to take actions that increase their cash bonus because they do not view their own performance as influencing company performance or share price
 - SEC believes that broader discussion than just executive compensation may be required because there may be business units with compensation structures that disproportionately reward risk [e.g., Citibank's Phibro energy trading business]

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Disclosure (cont'd)

- The Rule includes the following examples of compensation policies that may trigger disclosure:
 - policies at a business unit that carries a significant portion of the company's risk profile
 - policies at a business unit with compensation structured significantly differently than other units
 - policies at a business unit that is significantly more profitable than other units
 - policies at a business unit where compensation expense is a significant percentage of the unit's revenues
 - compensation policies or practices that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Disclosure (cont'd)

- If the compensation policies or practices create risks that are reasonably likely to have a material adverse effect, company must disclose how its compensation policies and practices relate to risk-taking incentives and risk management practices
 - If such disclosure is required, among the examples of disclosures that may be applicable are:
 - the company's risk assessment considerations in structuring its compensation policies and practices
 - how the company's compensation policies and practices relate to the realization of risk, such as through holding periods or clawback policies
 - the extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees
- The new disclosure does not need to be included in the CD&A disclosure, as originally proposed
- In the adopting release, the SEC confirms that there is no requirement for a company to make an affirmative statement that it has determined that the risks arising from its compensation policies are not reasonably likely to have a material adverse effect
- Smaller reporting companies (i.e., companies with a public float of less than \$75 million) will not be required to provide the new compensation disclosure

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Disclosure (cont'd)

- Significantly, the final rule includes a higher disclosure threshold than the proposed rule - - disclosure only is required where the risks arising from the compensation policies or practices ***are reasonably likely to have a material adverse effect*** on the company
 - As originally proposed, disclosure would have been required if the risks *may have* a material effect
 - SEC has clarified that in determining whether the "reasonably likely" disclosure threshold is met, the company may take into account plan features and policies that mitigate risk (e.g., holding periods, clawback policies, mix of short and long-term incentives)
 - Given the higher disclosure threshold, it is unlikely that many companies will determine that they have compensation policies or practices that require the prescribed risk disclosure
 - there could be a concern that disclosure of compensation policies which are reasonably likely to have a material adverse effect would raise questions as to whether a company's board of directors had properly discharged its fiduciary duties

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Disclosure (cont'd)

- The SEC notes in the adopting release that the "reasonably likely" disclosure threshold is the same standard found in the MD&A disclosure item with regard to known trends and uncertainties
 - "Reasonably likely" standard is a lower disclosure threshold than "more likely than not"
 - "Reasonably likely" standard is different than the Rule 10b-5 "probability/magnitude" materiality standard, which would require disclosure of an event with a low probability of occurrence where the magnitude (or dollar amount) of the consequences would be great
 - In the MD&A context, the SEC has prescribed a two-part test to determine whether a known trend or uncertainty is "reasonably likely":
 - First, management must assess whether the known trend or uncertainty is likely to come to fruition. If management determines that it is not reasonably likely to occur, no disclosure is required;
 - If management cannot make that determination, management must evaluate objectively the consequences of the known trend or uncertainty on the assumption that it will come to fruition. Unless management determines that a material effect is not reasonably likely to occur, disclosure is required.
 - Applying this test to the compensation risk disclosure, the two-part test for determining whether disclosure is required is:
 - First, management must assess whether the risk arising from the compensation policies or practices is likely to come to fruition. If management determines that it is not reasonably likely for the risk to come to fruition, no disclosure is required;
 - If management cannot make that determination, management must evaluate objectively the consequences of the risks coming to fruition. Unless management determines that a material adverse effect is not reasonably likely to occur, disclosure is required.

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Assessment

- Evolving; no standards or convention on how to conduct compensation risk assessment
- SEC Rule does not expressly require that a company conduct a formal compensation plan risk assessment, as required for TARP recipients under the Emergency Economic Stabilization Act of 2008, as amended by the American Recovery and Reinvestment Act of 2009
 - however, it is expected that companies will conduct risk assessments in order to support their disclosures (including the conclusion that no disclosure is required that compensation programs are reasonably likely to have a material adverse effect)

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Assessment (cont'd)

- For TARP recipients, Treasury Department Interim Final Rules published on June 15, 2009 set forth certain standards governing compensation risk assessment:
 - Compensation committee is required, at least every six months, to discuss, evaluate and review with the company's senior risk officer any risks (including long-term as well as short-term) that the company faces that could threaten its value
 - Compensation committee must identify the features in the senior executive officer compensation plans that could lead these executives to take these risks
 - focus is on plan features that would encourage behavior focused on short-term results rather than long-term value creation
 - compensation committee is required to limit these features
 - Compensation committee must identify the features in the employee compensation plans that pose risks to the company
 - focus is on plan features that would encourage behavior focused on short-term results rather than long-term value creation
 - compensation committee is required to limit these features
 - Compensation committee is required annually to provide a narrative explanation of how plan features do not encourage unnecessary and excessive risks, including how plans do not encourage behavior focused on short-term results rather than long-term value creation

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Assessment (cont'd)

- Process:
 - Senior risk officer with support from HR, Internal Audit and advisers (compensation consultants; legal) prepares report for Compensation Committee
 - Compensation Committee to coordinate its review with Audit/Risk Committee
- Scope of review:
 - identify risks
 - in certain scenarios, features in compensation plans may lead employee to take specifically identified company risks (e.g., credit, liquidity, compliance, reputational) and analysis of relationship between compensation plans and such risks is part of risk assessment
 - for many companies, however, most meaningful part of risk assessment will be to analyze compensation plan features to determine whether plans are properly balanced to appropriately incentivize long-term value creation and contain appropriate risk mitigation features
 - review compensation arrangements
 - focus on incentive arrangements
 - also consider severance/golden parachute arrangements
 - analyze compensation plans to assess whether design and/or mix promote risk as opposed to incentivizing long-term value creation
 - identify risks that may be encouraged by compensation plans.
 - for example, an incentive arrangement that gives undue weighting to revenue growth may encourage risky acquisitions

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Assessment (cont'd)

- does compensation plan design and mix promote long-term value creation?
 - analyze whether compensation arrangements at business units promote company risk
- consider time horizon of risks versus measurement period for incentive compensation
 - may be difficult to measure time horizon; make informed judgment
- consider whether compensation programs have risk mitigation features/policies
- risk analysis also should include an analysis of any of the following policies (specifically identified as potentially requiring disclosure in the SEC rule) to evaluate whether any such policies may create risks that are reasonably likely to have a material adverse effect:
 - policies at a business unit that carries a significant portion of the company's risk profile
 - policies at a business unit with compensation structured significantly differently than other units
 - policies at a business unit that is significantly more profitable than other units
 - policies at a business unit where compensation expense is a significant percentage of the unit's revenues
 - compensation policies or practices that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time
- is it sufficient for the analysis to be limited to an analysis of the compensation programs, without considering relation to specifically identified company risks?
 - arguably, properly balanced and structured plans should never cause “compensation” risk

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Assessment (cont'd)

- Scenario analysis
 - consider range of payout outcomes based on different performance scenarios and whether employees are incentivized to take inappropriate risks
 - consider whether there is any relationship between company risks (e.g., credit risk, compliance risk, reputational risk) and the components and performance metrics of the compensation programs
 - consider whether compensation plan features may truly reward employees for short-term results without regard to long-term value creation
 - since not all risks may be identified, it is important to evaluate compensation plan features separate from identified risks
 - backward looking reports should analyze relationship between payouts and risk outcomes
- Which employees to analyze?
 - executives
 - other employees

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Compensation Risk Assessment (cont'd)

- What to disclose?
 - SEC rule only requires disclosure where compensation policies and practices create risks that are reasonably likely to have a material adverse effect
 - for the overwhelming majority of companies which do not meet this disclosure threshold, likely that companies will nevertheless disclose:
 - their risk assessment process
 - a discussion of their compensation plan features that incentivize long-term value creation and provide appropriate balance between short and long-term compensation; appropriateness of performance metrics
 - their compensation plan risk mitigation features and policies

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

What kinds of compensation policies may encourage risk?

- excessive use of stock options
 - concern is that these awards are leveraged and thereby encourage risk, with no downside risk to executives
- low base salary
- reliance on annual incentive awards with potential for outsize maximum payouts or uncapped payouts
- design feature where small increase in performance metric may result in large increase in award payout
- use of or overweighting of a single performance metric
- quarterly bonus payouts
- short-term vesting of equity awards
- disproportionate weighting of revenue growth may incentivize risky acquisitions
- not including risk mitigation features/policies

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Board's Role in the Risk Oversight Process

- New disclosure item requires disclosure of the Board's role in risk oversight and the effect on the board's leadership structure
- Should address, where material, credit risk, liquidity risk and operational risk
- Should provide information about the relationship between the Board and senior management in managing the material risks facing the company
- Does the Board oversee risk at the Board level or through a Committee, and why?
- Do the managers who manage risk report to the Board or a Committee?
 - is there a chief risk officer?
 - what is the role of the CEO in risk management?

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

New Disclosure Regarding Compensation Consultants

- SEC notes that fees earned by compensation consultants for services such as benefits administration, human resources consulting and actuarial services may be more significant than the fees paid to them for consultation, benchmarking and recommendations on executive compensation
- Investors have expressed concern about these conflicts and the objectivity of compensation consultants in making executive compensation recommendations
- Disclosure is intended to minimize potential conflicts of interest
- Proxy disclosure amendments require disclosure of:
 - if the compensation consultant was engaged by the Compensation Committee (and other than in cases where the consultant's role is limited to advising on broad-based plans or providing information that is not customized or customized based on parameters not developed by the consultant)
 - and if the compensation consultant or its affiliates also provided additional services to the company in an amount in excess of \$120,000 during the last fiscal year, disclose both (i) the aggregate fees for executive and director compensation consulting services and (ii) the aggregate fees for such other services, and (iii) whether the decision to engage the compensation consultant or its affiliates for the other services was made, or recommended by management, and whether the Compensation Committee or the Board approved such other services

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

New Disclosure Regarding Compensation Consultants (cont'd)

- If the Compensation Committee did not engage a compensation consultant, but management engaged a compensation consultant (other than for the limited roles noted above)
 - and if the compensation consultant or its affiliates also provided additional services to the company in an amount in excess of \$120,000 during the last fiscal year, disclose both (i) the aggregate fees for executive and director compensation consulting services and (ii) the aggregate fees for such other services
- Additional disclosures not required in cases where the Compensation Committee retains its own compensation consultant (which does not provide non-executive compensation consulting services in excess of \$120,000) and the company engages its own compensation consultant to provide executive compensation and additional consulting services (even if in excess of \$120,000)
- In response to pending legislative proposals, evolving best practices and new compensation consultant disclosure requirements, more companies are engaging independent compensation consultants who do not furnish additional services and also are establishing independence criteria for their compensation consultants
- Need disclosure controls to identify payments made to compensation consultants and determine whether there are any non-executive (director) compensation consulting services

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Disclosure of Stock and Option Awards

- Amended rules require disclosure in the Summary Compensation Table and Director Compensation Table of the grant date fair value of the awards computed under FASB ASC Topic 718 (formerly FAS 123R)
- Previously, the compensation tables reported the dollar amount recognized for financial statement reporting purposes, which includes historical awards
- Performance-based awards should be computed on the basis of the probable outcome of the performance conditions as of the grant date, consistent with FASB ASC Topic 718
 - this is a change from the proposed rule which would have required full grant date value based on maximum achievement of performance goals
 - however, footnote disclosure of the maximum value based on maximum achievement is required
 - effects of forfeitures should be excluded
- Change should result in disclosure that aligns better with how compensation decisions were made for the reported fiscal year and disclose a figure that correlates to compensation decisions made in the most recent fiscal year

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Disclosure of Stock and Option Awards (cont'd)

- The change also avoids distortions that might result where cash settled and performance-based awards granted in prior periods result in negative numbers in the Summary Compensation Table (e.g., where it is determined that the performance condition is no longer probable)
- New rules also will affect the calculation of total compensation and the determination of the named executive officers (other than the CEO and CFO) in the Summary Compensation Table
- To facilitate year to year comparisons, prior year stock and option awards need to be recomputed (as of their grant dates) for the named executive officers
 - where executive was a named executive officer in third most recent fiscal year but not second most recent fiscal year, compensation for each of the three years is required to be reported
 - not necessary to re-determine who would have been named executive officers in second and third most recent fiscal years

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Enhanced Director and Nominee Disclosure

- Amended rule now requires disclosure on a person-by-person basis for each director or nominee of "the specific experience, qualifications, attributes or skills" that led the board to conclude that the person should serve as a director in light of the company's business and structure. If material, this disclosure should cover more than the past five years, and include information about the person's particular areas of expertise or other relevant qualifications.
 - final rule does not require disclosure of specific experience, qualifications or skills that qualify a person to serve as a committee member
 - final rule does not specify any particular information that should be disclosed, such as risk assessment skills (as originally proposed)
 - final rule is targeted to require specific disclosures about qualifications and experience of individual directors/nominees
- In addition to current directorships, any directorships during the prior five years would be required to be disclosed (even if the nominee or director is no longer serving)
- Disclosure of legal proceedings (which also applies to executive officers) has been extended to cover the past ten (10) years (rather than five years) and the kinds of legal proceedings required to be disclosed have been expanded

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Enhanced Director and Nominee Disclosure (cont'd)

- Amended rules now require disclosure of whether, and if so how, the nominating committee or board considers diversity in identifying nominees for director
 - SEC leaves companies to determine how they define diversity
 - SEC states: "some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin."
- If the nominating committee or board has a policy with regard to the consideration of diversity, disclosure is required of how this policy is implemented, as well as how the effectiveness of the policy is assessed

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Board Leadership Structure

- New disclosure requires description of leadership structure of the board, such as whether the same person serves as Chairman and CEO
 - disclose whether and why the company has chosen to combine or separate the principal executive officer and board chair positions
- If the same person serves as Chairman and CEO, disclose whether there is a lead director and the specific role of the lead director
- Disclosure should include explanation of why the company has determined that its leadership structure is appropriate for the company, given its characteristics and circumstances
 - intended to increase transparency as to how the board functions

SEC Rules for Expanded Compensation and Corporate Governance Disclosures (cont'd)

Current Reporting of Meeting Voting Results on Form 8-K

- SEC moved the existing required disclosure of meeting voting results from Forms 10-Q and 10-K to new Item 5.07 of Form 8-K
- Required to be filed within 4 business days of the shareholders meeting
 - company may file preliminary voting results within the initial 4-day period, and then file an amended Form 8-K within 4 business days after the final voting results are known

Compensation and Risk; Best Practices

Obama Administration Broad-Based Pay Principles

On June 10, 2009, Treasury Secretary Geithner issued a statement setting forth broad-based principles underlying the Obama Administration's reforms designed to align compensation practices with sound risk management and long-term growth.

These principles are:

- Compensation plans should properly measure and reward performance
 - the Statement notes that incentive-based compensation may be undermined by improper benchmarking
 - the Statement notes that performance-based pay should be conditioned on a wide variety of internal and external metrics and not just stock price
- Compensation should be structured to account for the time horizon of risks
 - a contributing factor to the financial crisis was that compensation could be earned on a current basis without regard to risks that short-term actions produced
 - the Statement suggests that stock retention requirements may be the most effective device, and that long-term performance plans and clawbacks may also achieve this goal

Compensation and Risk; Best Practices (cont'd)

Obama Administration Broad-Based Pay Principles (cont'd)

- Compensation practices should be aligned with sound risk management
 - the Statement notes that Compensation Committees should be required to conduct and publish risk assessments of compensation practices to ensure that they do not encourage imprudent risk-taking
- Golden parachutes and supplemental retirement packages should align the interests of executives and shareholders
 - the Statement calls for a re-examination of golden parachutes and SERPS to determine whether they incentivize performance and whether they reward executives even if shareholders lose value
- There should be greater transparency and accountability in the process of setting compensation
 - the Statement calls for greater independence on the part of Compensation Committees and greater transparency in compensation disclosures
 - the Statement also supports "say-on-pay" legislation in order to improve directors' accountability

Compensation and Risk; Best Practices (cont'd)

Conference Board Task Force on Executive Compensation

- The Conference Board issued a report in September 2009 with recommendations for public company compensation arrangements
- The Report includes five "guiding principles" for executive compensation
- Principle One: A significant portion of pay should be incentive compensation, with payouts demonstrably tied to performance and paid only when performance can be reasonably assessed
 - companies should utilize performance measures that incentivize achievement of their business strategies and in a manner consistent with the company's values
 - incentive compensation should be designed to reward long-term value creation
 - incentive compensation arrangements should take into account risks associated with the various performance metrics
 - incentive compensation arrangements should not encourage excessive or inappropriate risk taking, nor discourage an appropriate level of risk taking
 - incentive plans may incorporate bonus banking, deferred bonuses, longer-term performance periods, vesting and holding periods to mitigate risk and also to more closely align payouts with risks and properly measure performance
 - clawback policies should be adopted to address inappropriate payouts

Compensation and Risk; Best Practices (cont'd)

Conference Board Task Force on Executive Compensation (cont'd)

- incentive compensation should be paid only when performance can be reasonably measured
- compensation programs need to promote an appropriate balance of a company's short and long-term objectives
- the portion of total compensation at risk that is based on performance should increase with an executive's role and responsibilities
- stock ownership programs aid in aligning the interest of executives with shareholders and can encourage executives to focus on the longer term
- performance targets should be realistic, neither too easy nor too difficult
 - in assessing whether targets are appropriate, a compensation committee should consider appropriate information regarding the company's industry, industry and company growth rates, historical targets and actual performance relative to those targets, investor expectations, and key competitors and their performance levels. Analyst reports and expectations also may be considered
 - consideration should be given to deciding whether performance should be measured on an absolute basis or on a relative basis, such as an index or a peer group
 - an appropriate relationship between payouts at threshold, target and maximum levels needs to be set. Steeper curves create the potential for small changes to produce large compensation differentials, which can incentivize risk taking

Compensation and Risk; Best Practices (cont'd)

Conference Board Task Force on Executive Compensation (cont'd)

- In determining payouts, compensation committees should consider the extent to which performance has been significantly influenced by external circumstance; compensation committees should consider whether greater discretion in measuring performance or in adjusting payouts should be used
- Principle Two: Total compensation should be attractive to executives, affordable to the company, proportional to the executive's contribution, and fair to shareholders and employees, while providing payouts that are clearly aligned with actual performance
 - this principle focuses on properly executed benchmarking. The Report notes that poorly executed benchmarking, coupled with widespread targeting of above-median pay levels has contributed to an upward spiral of executive pay
 - Compensation committees should develop robust criteria for determining peer companies
 - the Report notes that the proper use of benchmarking requires the proper selection of the peer group and appropriate targets in comparison to peers
 - if a company provides target levels of pay at or above a particular percentile and does not perform at that percentile of peer companies, the company should redesign its compensation programs
 - companies should target above-median pay only when there is appropriate justification

Compensation and Risk; Best Practices (cont'd)

Conference Board Task Force on Executive Compensation (cont'd)

- in evaluating affordability, compensation committees may examine the percentage of a company's earnings, incremental earnings or of other metrics paid to executives; if available, comparative peer company data may be used
- Principle Three: Companies should avoid controversial pay practices, unless special justification is present
 - certain pay practices provide payouts to executives without regard to performance or by inappropriately differentiating between executives and other managers. These practices undermine performance based compensation and undermine credibility and trust of key constituencies. These controversial pay practices include:
 - multi-year employment agreements providing generous severance payments
 - overly generous golden parachutes
 - gross-ups on parachute payments or perquisites
 - SERPs
 - golden coffins
 - perquisites that are not generally available to other managers
 - above market returns on deferred compensation
 - stock option repricings that are not value neutral, nor approved by shareholders

Compensation and Risk; Best Practices (cont'd)

Conference Board Task Force on Executive Compensation (cont'd)

- if circumstances warrant and one or more of these practices is used, the rationale should be disclosed to shareholders (e.g., where necessary to recruit an executive)
- Principle Four: Compensation Committees should demonstrate credible oversight of executive compensation
 - to fulfill this role, Compensation Committees should have access and control the engagement of key advisors, who should be independent of management
 - Compensation Committee should have direct oversight of the named executive officers and all direct reports of the CEO and/or Section 16 officers.
- Principle Five: Compensation programs, including their rationale, should be transparent, understandable and effectively communicated to shareholders. When questions arise, boards and shareholders should have meaningful dialogue about executive compensation
 - compensation disclosures should demonstrate that the metrics of the compensation programs are linked to specific measures of business performance, and should present the business goals and rationale for the performance metrics
 - CD&A should be a communications vehicle with shareholders rather than just a compliance document
 - a "say-on-pay" vote alone is not an adequate dialogue

Compensation and Risk; Best Practices (cont'd)

Federal Reserve Proposed Guidance

- On October 22, 2009, the Federal Reserve issued proposed guidance for incentive compensation for banking institutions
 - although limited in applicability to banking institutions, the guidance may influence actions by other regulators and constituencies
- Guidance applies to all employees who have the ability to affect the risk profile of an organization, either individually or as part of a group
- Federal Reserve Chairman Ben S. Bernanke states:
 - "Compensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability. The Federal Reserve is working to ensure that compensation packages appropriately tie rewards to longer-term performance and do not create undue risk for the firm or the financial system."
- Guidance is based on three key principles that are designed to ensure that incentive compensation arrangements do not encourage employees to take excessive risks
- Principle 1: Incentive compensation arrangements should provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk
 - because risk outcomes may become clear only over a period of time, incentive compensation arrangements should take into account the risks as well as the current financial benefits from an employee's activities

Compensation and Risk; Best Practices (cont'd)

Federal Reserve Proposed Guidance (cont'd)

- under a balanced incentive compensation arrangement, two employees who generate the same profit for an organization should not receive the same compensation if the risks taken in generating the profits are materially different
- consider full range of risks associated with an employee's activities -- credit, market, liquidity, operational, legal, compliance, reputational
- consider the time horizon over which the risks may be realized
- utilize scenario analysis -- evaluation of payment outcomes based on range of performance levels, risk outcomes and levels of risk taken
- the Guidance describes four methods to make compensation arrangements more sensitive to risk:
 - adjusting the amount of an incentive compensation award to take into account the risks posed by the employee's activities
 - defer payment of award beyond performance period and adjust payout based on outcomes relating to performance that occur after performance period
 - use longer performance periods
 - reduce the magnitude of risk-taking incentives by reducing the sensitivity of performance measures (i.e., small change in performance metric should not result in disproportionate increase in incentive compensation)

Compensation and Risk; Best Practices (cont'd)

Federal Reserve Proposed Guidance (cont'd)

- the Guidance notes that deferred equity compensation may be effective in restraining the risk-taking incentives of senior executives, but may not be effective for other employees who are unlikely to believe that their actions will materially affect the organization's stock price
- Principle 2: Incentive compensation arrangements should be compatible with effective controls and risk management
 - organization should have strong controls governing its process for designing, implementing and monitoring incentive compensation arrangements
 - for example, policies and procedures need to identify risk-related inputs
 - risk management personnel should have input in the process for designing incentive compensation arrangements and assessing their effectiveness
 - risk management personnel should have appropriate skills and should be compensated in a manner to attract personnel with the requisite skills
 - track incentive compensation awards and payments, risks taken and actual risk outcomes to determine whether incentive compensation payments are appropriately reduced to reflect risk outcomes

Compensation and Risk; Best Practices (cont'd)

Federal Reserve Proposed Guidance (cont'd)

- Principle 3: Incentive compensation arrangements should be supported by strong corporate governance, including active and effective oversight by the board
 - Board should actively oversee the development and operation of the organization's incentive compensation arrangements
 - Board should ensure that incentive compensation arrangements are balanced and compatible with appropriate level of risk
 - Board should receive data and analysis from management or other sources to allow the Board to assess whether the design and operation of the incentive compensation arrangements are consistent with the organization's safety and soundness
 - Board should receive forward looking scenario analysis and backward looking reports to determine whether the incentive compensation arrangements may be promoting excessive risk taking
 - Board should have authority to retain outside counsel and consultants

Compensation and Risk; Best Practices (cont'd)

Federal Reserve Proposed Guidance (cont'd)

- The Guidance recommends the following elements to develop balanced incentive compensation arrangements.
 - identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks
 - identify the types and time horizons of risks from the activities of these employees
 - assess the potential for performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take excessive risks
 - include measures, such as risk adjustments or deferral periods within the compensation arrangements that are reasonably designed to achieve a balanced arrangement
 - communicate to employees the ways in which their incentive compensation will be adjusted to reflect risk
 - monitor incentive compensation awards, payments, risks taken and risk outcomes and modify the arrangements if payments are not appropriately sensitive to risk and risk outcomes

Compensation and Risk; Best Practices (cont'd)

What are some best practices in designing compensation policies that may serve to reduce risk?

- Shifting the weighting of incentive compensation toward long-term incentives
- Balance and diversity of performance measures
- Performance relative to peer companies as a metric
- Long vesting periods for equity incentives
- Deferring portion of cash incentive awards into restricted stock
- Stock ownership requirements
- Hold equity until or through retirement requirements
- Clawbacks
- Alignment of performance measures with business strategy
- "Bonus banking"
- Committee discretion to adjust awards based on "quality" of performance
- Sunset provisions for golden parachutes

Compensation and Risk; Best Practices (cont'd)

What is "bonus banking"?

- Bonus banking is an incentive plan where part of the bonus earned in a year is “banked” in a bonus account, to be paid out in subsequent years.
- Allows for the declaration of a negative bonus (sometimes called a “malus”) where the amount in the bonus bank is reduced if subsequent corporate or individual performance declines, or if the initial assessment of performance upon which the bonus was based turns out to be wrong.
- Similar in effect to a “clawback”
 - triggers may be more far-reaching than a clawback
 - since the deferred portion of the bonus is held in escrow, enforceability of the device is better assured
- May produce challenges in properly motivating participants

Clawbacks

What are clawback policies?

Clawbacks refer to recouping compensation that a company has previously paid. Clawbacks can refer to a range of policies, ranging from policies which apply only to cases of a material restatement due to fraud, to policies which apply where any incentive-based compensation is based on inaccurate criteria, to policies which apply where an executive has engaged in different types of misconduct:

- A number of companies adopted clawback policies modeled on Section 304 of the Sarbanes-Oxley Act, which provides for recoupment in cases of financial statement restatement where there has been material noncompliance with financial reporting requirements under the securities laws, due to misconduct. Recoupment may apply to bonuses or other incentive-based compensation or equity-based compensation received by the executive, as well as profits realized from the sale of securities, during the 12-month period following publication of the financial statements that are later restated.

Clawbacks (cont'd)

What are clawback policies? (cont'd)

- More recently, pursuant to the Emergency Economic Stabilization Act ("EESA") and implementing Treasury regulations, TARP recipients have adopted clawback policies providing for recoupment of any bonus, retention award, or incentive compensation paid to a Senior Executive Officer and any of the next twenty most highly compensated employees of the TARP recipient if the compensation was based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.
 - whereas the SOX clawback is limited to the CEO and CFO, the TARP clawback applies to the named executive officers in the proxy statement and the next 20 most highly compensated employees
 - the recovery period is not limited
 - no need for a restatement; no need for material non-compliance; no need for misconduct
 - applies if compensation is based on any materially inaccurate metric
- Some companies have adopted clawbacks to provide for recoupment in cases of non-compete covenant violations and similar misconduct
- To date, there have not been any significant number of companies which have adopted clawbacks that are triggered where it is later determined that executives engaged in conduct that subjected the company to risk or otherwise were not in the long-term interests of the company

Clawbacks (cont'd)

What are the principal design questions that need to be addressed in formulating a clawback policy?

- Limit to Section 16 officers or also include accounting officers or apply more broadly?
- Provide for enforceability by incorporation into agreements or awards?
- Provide discretion on the part of the Board or Compensation Committee to enforce?
- Should trigger be limited to a material financial statement restatement or apply where compensation is based on any inaccurate metric?
- Should trigger be limited to cases of misconduct?
- Should recoupment be limited to incentive-based awards where payout was specifically based on financial or other metrics?
 - depending on the trigger, some policies apply to equity-based compensation and/or proceeds and/or gains realized from the sale of equity
- Should there be different levels of recoupment depending on the triggers?
- Should there be a time period for limiting any recoupment?

Clawbacks (cont'd)

Are more companies including clawback provisions in their executive compensation arrangements?

- An increasing number of companies are adopting clawback policies or modifying previously adopted clawback policies to comply with best practices
- Increasingly popular shareholder proposal

Shareholder Proposals Relating to Executive Compensation

- In 2009, many companies received shareholder proposals requesting that the board take certain actions relating to executive compensation
- Compensation-related shareholder proposals included:
 - **Say-on-Pay:** Requests that the board adopt a policy providing shareholders with an advisory vote on executive compensation
 - **Golden Parachutes:** Requests that the board seek shareholder approval for future severance agreements with senior executives, or adopt a policy imposing limitations on severance pay
 - **Tax Gross-Ups:** Requests that the board adopt a policy that the company will not make or agree to make any tax gross-up payment to its senior executives
 - **Pay for Performance:** Requests that the board adopt one or more measures to link executive pay to the company's performance (e.g., through the adoption of performance-based options or performance-based restricted stock)
 - **Golden Coffins:** Requests that the board adopt a policy of obtaining shareholder approval for any future agreements or corporate policies that would obligate the company to make payments, grants, or awards following the death of an executive officer
 - **SERP Policy:** Requests that the board adopt changes to the company's method of calculating supplemental executive retirement plan (SERP) payments

Shareholder Proposals Relating to Executive Compensation (cont'd)

- Compensation-related shareholder proposals (cont'd):
 - **Clawback Policy:** Requests that the board adopt a policy to recoup future compensation paid to senior executive officers to the extent that the compensation was based on fraudulent or illegal conduct or other similar misconduct.
 - **Independent Compensation Consultant:** Requests that the board's compensation committee be required to hire its own compensation consultant (i.e., separate from any compensation consultant advising management)
 - **Equity Retention Requirements:** Requests that the board adopt a policy requiring an executive officer to retain a certain percentage of shares acquired through the company's compensation policy for a specified time period after his or her termination
 - **Bonus Banking:** Requests that the board revise the company's annual bonus plan to require that a portion of any bonus payments be deferred and contingent upon the performance of the company during the deferral period
 - **TARP-Related Proposals:** For companies participating in the TARP, requests that the board implement specified limitations on senior executive compensation (e.g., limits on bonus and severance payments, requirements that majority of long-term compensation be in form of performance-vested equity instruments, freezes on new stock option awards unless indexed to peer group performance, etc.)

Shareholder Proposals Relating to Executive Compensation (cont'd)

- Under certain circumstances, a company is permitted to exclude a shareholder's proposal from its proxy statement. In order to do so, the company must first seek no-action relief from the SEC pursuant to Rule 14a-8 under the Exchange Act
- The substantive bases upon which a company may exclude a shareholder proposal include, among others, the following:
 - the proposal deals with a matter relating to the company's ordinary business operations
 - **Note:** matters involving executive compensation (as opposed to general employee compensation) are not excludable under this basis
 - the proposal is not a proper subject for action by shareholders under state law
 - the proposal would, if implemented, cause the company to violate the law
 - the proposal or supporting statement is contrary to any of the SEC's proxy rules (e.g., it includes a materially false or misleading statement)
 - the company would lack the power or authority to implement the proposal
 - the company has already substantially implemented the proposal
- In addition to these and other substantive bases for exclusion, there are also a number of procedural bases upon which companies have excluded compensation-related proposals (e.g., where the proponent has failed to establish that it has met certain stock ownership and holding period rules)

Legislative Developments

Over the past year, there has been significant legislative activity that could ultimately result in significant changes to laws governing executive compensation and corporate governance

Among the legislative proposals are the following:

- The Obama Administration's Investor Protection Act of 2009
- Rep. Barney Frank's "Corporate and Financial Institutions Compensation Fairness Act of 2009" (as incorporated into the "Wall Street Reform and Consumer Protection Act of 2009", the House's comprehensive financial regulatory reform bill)
- Sen. Charles Schumer's "Shareholder Bill of Rights Act of 2009"
- Rep. Gary Peters' "Shareholder Empowerment Act of 2009"
- The Senate Banking Committee's Financial Reform Discussion Draft
- Sen. Carl Levin's and Sen. John McCain's "Ending Excessive Corporate Deductions for Stock Options Act"
- Sen. Richard Durbin's "Excessive Pay Shareholder Approval Act of 2009"
- Rep. Keith Ellison's "Corporate Governance Reform Act of 2009"

Legislative Developments (cont'd)

Investor Protection Act of 2009

On July 16, 2009, the Treasury Department delivered draft legislation to Congress providing for (i) say-on-pay and (ii) enhanced Compensation Committee and compensation consultants independence

- Provides for "say-on-pay" vote on executive compensation
 - similar to Barney Frank legislation (see Slide 55)
- Also provides for vote on golden parachutes
 - similar to Barney Frank legislation
- Also provides for enhanced independence requirements for members of Compensation Committees
 - provides for additional requirement that member of Compensation Committee may not receive any remuneration other than as a director or be an affiliated person (same standard as for Audit Committees under SOX)
 - under current NYSE and Nasdaq listing requirements, members of Compensation Committees already are required to be independent
- Also provides that compensation consultants and legal advisers to Compensation Committees must be independent
 - imposes independence requirement on legal advisers
 - provides for SEC to adopt rules prescribing standards for independence

Legislative Developments (cont'd)

Investor Protection Act (cont'd)

- Compensation Committee shall have authority and funding to retain (and shall be directly responsible for appointment, compensation and oversight of) independent compensation consultant and independent legal counsel
 - if Compensation Committee does not engage its own compensation consultant, it must explain the decision to its shareholders
 - currently, it is common practice for Compensation Committees to have authority to retain advisers

Legislative Developments (cont'd)

Corporate and Financial Institution Compensation Fairness Act of 2009 (H.R. 3269)

- Sponsored by Rep. Barney Frank (D-MA)
- Passed House vote on July 31, 2009; awaiting Senate action (referred to Senate Committee on Banking, Housing and Urban Affairs on August 3, 2009)
- **Note:** An identical version of this legislation was passed by the House on December 11, 2009 as Title II of the “Wall Street Reform and Consumer Protection Act of 2009”
- Provides for annual "say-on-pay" vote for named executive officers
 - vote would apply to compensation as disclosed in the proxy statement, including compensation tables and CD&A
 - shareholder vote not binding on the issuer or its board
 - shareholder vote will not create or imply any fiduciary duty
- Separate vote on anticipated golden parachute payments to named executive officers in proxy statements calling for shareholder approval of a change in control transaction
 - vote not required on agreements or arrangements previously subject to a “say-on-pay” vote
 - shareholder vote not binding on the issuer or its board
 - shareholder vote will not create or imply any fiduciary duty

Legislative Developments (cont'd)

Corporate and Financial Institution Compensation Fairness Act of 2009 (H.R. 3269) (cont'd)

- Investment managers subject to Section 13(f) must disclose how they voted in any advisory vote on executive compensation or golden parachutes.
- If the legislation is passed, the SEC would be required to issue final rules within six (6) months of the legislation's enactment to implement the Act's say-on-pay and golden parachute provisions. These provisions would apply only to annual meetings occurring on or after the six (6) month anniversary of the SEC's adoption of such final rules.

New listing standards governing Compensation Committees

- SEC required to adopt rules to be effective no later than nine (9) months after enactment
- Members of Compensation Committee must satisfy independence standards similar to Audit Committee members
 - may not receive any consulting, advisory or other compensatory fee (other than as a Board or Committee member)
- Compensation Committee must have authority to retain independent compensation consultant
 - SEC to adopt rules prescribing standards for independence

Legislative Developments (cont'd)

Corporate and Financial Institutions Compensation Fairness Act of 2009 (cont'd)

- Compensation Committee is directly responsible for the appointment, compensation and oversight of the independent compensation consultant
- Compensation Committee also must have authority to retain independent counsel
- Proxy statement must disclose whether the Compensation Committee retained an independent compensation consultant
- Compensation Committee charters will need to conform to new listing standards

Legislation also provides for federal regulatory agencies to adopt new rules to require covered financial institutions to disclose information about incentive based compensation in order to determine whether the arrangements (i) are aligned with sound risk management and (ii) are structured to account for the time horizon of risks

Legislative Developments (cont'd)

Shareholder Bill of Rights Act of 2009 (S. 1074)

- Sponsored by Sen. Charles Schumer (D – NY)
- Introduced on May 19, 2009; referred to House Committee on Banking, Housing and Urban Affairs
- The Bill begins with the following finding:

"among the central causes of the financial and economic crises that the United States faces today has been a widespread failure of corporate governance"

The proposed legislation would provide for the following:

- Proxy statements that include compensation disclosures (i.e., the annual proxy statement) must include a non-binding shareholder advisory vote on executive compensation
- Proxy statements relating to mergers and similar transactions must include disclosures concerning golden parachute arrangements (which otherwise have not been disclosed and subject to a shareholder advisory vote) which shall be subject to a non-binding shareholder advisory vote

Legislative Developments (cont'd)

Shareholder Bill of Rights Act of 2009 (cont'd)

- Directs the SEC to promulgate rules that would provide shareholders with access to public company proxy statements for nominating directors
 - the SEC's proxy access rules would be required to include a requirement that the nominating shareholder have held 1% or more of the issuer's voting securities for at least the two-year period preceding the shareholder meeting
- The SEC must adopt rules requiring stock exchanges to enhance their listing standards. Under the proposed rules:
 - the chairperson of the board must be independent and not have served previously as an executive officer of the company
 - directors must be elected on an annual basis (i.e., no staggered boards)
 - directors must be elected by a majority vote (i.e., not by a plurality vote unless the election is contested)
 - listed companies must establish a Risk Committee comprised of independent directors

Legislative Developments (cont'd)

Shareholder Empowerment Act of 2009 (H.R. 2861)

- Sponsored by Rep. Gary Peters (D – MI)
- Introduced June 12, 2009; referred to House Committee on Financial Services on June 12, 2009

The proposed legislation would provide for the following:

- The SEC must adopt rules requiring stock exchanges to enhance their listing standards, including:
 - the chairperson of the board must be independent and not have served previously as an executive officer of the company
 - directors must be elected by a majority vote (i.e., not by a plurality vote unless the election is contested)
- Directs the SEC to promulgate rules that would provide shareholders with access to public company proxy statements for nominating directors
 - as under the Schumer bill, the SEC's proxy access rules would be required to include a requirement that the nominating shareholder have held 1% or more of the issuer's voting securities for at least the two-year period preceding the shareholder meeting

Legislative Developments (cont'd)

Shareholder Empowerment Act of 2009 (cont'd)

- Elimination of broker discretionary voting in uncontested elections
- Proxy statements must include a non-binding shareholder advisory vote on executive compensation
- The SEC must adopt rules providing that outside compensation consultants must be independent and report solely to the Board or its Compensation Committee
- The SEC must adopt rules requiring stock exchanges to enhance their listing standards to (i) require companies to adopt clawback policies and (ii) prohibit severance agreements which provide for payments to an officer who is terminated because of poor performance
- The SEC must adopt rules requiring additional disclosure of performance targets used to determine senior executive officer incentive compensation

Legislative Developments (cont'd)

Senate Banking Committee's Financial Reform Discussion Draft

- On November 10, 2009, Sen. Christopher Dodd (D – CT) and fellow Democrats on the Senate Banking Committee publicly released a discussion draft of a comprehensive financial reform bill entitled the “Restoring American Financial Stability Act” (the “Senate Discussion Draft”).
- While the majority of the Senate Discussion Draft is specific to the financial sector, it does include a number of corporate governance and executive compensation provisions that would apply to public companies generally.

The Senate Discussion Draft would provide for the following:

- Proxy statements that include compensation disclosures (i.e., the annual proxy statement) must include a non-binding shareholder advisory vote on executive compensation
- Proxy statement must provide for a non-binding shareholder advisor vote on the company's policy on golden parachute arrangements, unless such arrangements have previously been subject to a shareholder vote.

Legislative Developments (cont'd)

Senate Banking Committee's Financial Reform Discussion Draft (cont'd)

- New listing standards governing Compensation Committees
 - listed company required to have Compensation Committee consisting entirely of “independent” directors
 - SEC rules would require that exchanges consider the following factors in determining whether a board member is independent: (i) the source of compensation of the board member and (ii) whether the board member is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of the subsidiary of an issuer
 - independence requirements for compensation consultants, legal advisers, and other advisers to the Compensation Committee
- Annual proxy statement must include enhanced executive compensation disclosures, including:
 - information that shows the relationship between executive compensation and the financial performance of the company; and
 - a graphic or pictorial comparison of the amount of executive compensation and the financial performance of the company during a five (5) year period, or other period specified by the SEC
- Annual proxy statement must disclose whether its employees are permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities granted to employees by the company

Legislative Developments (cont'd)

Senate Banking Committee's Financial Reform Discussion Draft (cont'd)

- Any company subject to the Exchange Act's reporting requirements would be required to develop and implement a clawback policy that permits it to recover excess incentive-based compensation previously paid to current and former executive officers in the event the company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirements under the securities laws
- Directs the SEC to promulgate rules requiring stock exchanges to enhance their listing standards. Under the proposed rules:
 - no listed company may have a staggered board unless the shareholders of the company have approved the staggered board by a vote that would be required to amend the certificate of incorporation or bylaws of the company (as applicable, depending upon where the provision regarding the staggered board is located)
 - directors must be elected by a majority vote (i.e., not by a plurality vote unless the election is contested)
- Directs the SEC to promulgate rules that would provide shareholders with access to public company proxy statements for nominating directors
 - unlike the Schumer bill, the Discussion Draft does not specify an ownership threshold or holding period requirement
 - SEC would be required to promulgate such proxy access rules within 180 days of enactment of the legislation

Legislative Developments (cont'd)

Other Legislation

- Excessive Pay Shareholder Approval Act of 2009 (S. 1006)
 - sponsored by Sen. Richard Durbin (D – IL)
 - would prohibit a public company from providing compensation to an employee during any single taxable year that exceeds 100 times the average compensation for services performed by all the company's employees during such taxable year, *unless* at least sixty percent (60%) of the company's shareholders have voted to approve it
 - related Excessive Pay Capped Deduction Act of 2009 (S. 1007) would disallow the tax deduction for any such "excessive compensation"
- Corporate Governance Reform Act of 2009 (H.R. 3272)
 - sponsored by Rep. Keith Ellison (D – MN)
 - would require public companies to (i) have an independent chairperson; (ii) establish an independent risk management committee; (iii) designate a chief risk officer; (iv) have an independent compensation committee; and (v) provide for an annual say-on-pay vote
- Ending Excessive Corporate Deductions for Stock Options Act (S. 1491)
 - sponsored by Sen. Carl Levin (D – MI) and Sen. John McCain (R – AZ)
 - would (1) limit the employer tax deduction for stock options granted to its employees to the value of such options as recorded on the employer's books at the time such options are granted; and (2) apply the \$1 million limitation on the employer tax deduction for employee remuneration to stock option compensation

Say-on-Pay

What is Say-on-Pay?

- "Say-On-Pay" shareholder proposals are shareholder proposals calling for non-binding advisory votes on executive compensation.
- The boards of some public companies in the U.S. - including Intel and Aflac - have voluntarily approved resolutions giving shareholders a non-binding vote on executive compensation.
- Expect legislation mandating say-on-pay advisory votes to be adopted for non-TARP companies in 2010 to be effective for annual meetings in 2011
- Although all pending legislation provides for annual "say-on-pay" vote, some institutional investors and companies are advocating a triennial or biennial vote
 - Microsoft adopted a triennial "say-on-pay" vote
 - for 2010 proxy season, shareholders may continue to submit shareholder proposals for "say-on-pay." See Appendix A for list of 2009 "say-on-pay" proposals
- For those companies that have had "say-on-pay" votes, principally TARP companies, the overwhelming majority have garnered approval
- NYSE is working with SEC to amend Rule 452 so that brokers may not vote uninstructed shares on "say-on-pay" votes

Say-on-Pay (cont'd)

RiskMetrics will base its recommendation for voting on a "Say-On-Pay" proposal based on its assessment of the following questions:

- Does the company demonstrate a strong link between executive pay and performance?
- How does the company use employment agreements?
- Are severance and/or change-in-control provisions reasonable?
- Is the company's compensation peer group appropriate?
- Are the performance criteria and target thresholds appropriate?
- Is there significant pay disparity among top executives?
- What perquisites are provided to executives?
- Is the compensation disclosure clear and complete?
- Is the board responsive to investor input on compensation issues?

RiskMetrics' Executive Compensation Evaluation Policy

Background

- RiskMetrics is a risk management company. Among its businesses are to provide proxy advisory services to institutional shareholders. RiskMetrics' proxy advisory business was established by Institutional Shareholder Services (ISS) which was acquired by RiskMetrics in 2007. Although there are a number of other proxy advisory firms (including Glass Lewis), RiskMetrics' recommendations are followed or given weight by a number of institutional shareholders.
- RiskMetrics will evaluate and make recommendations on annual and special meeting voting for most all of the listed U.S. public companies.
- RiskMetrics also provides governance consulting services to public companies. This aspect of its business has led some commenters to say that RiskMetrics' proxy advisory services are subject to conflicts of interest where RiskMetrics is also providing governance consulting services.
- Each year, RiskMetrics publishes its governance policies. These represent RiskMetrics policies when evaluating public company voting proposals.
- With the elimination of broker discretionary voting, RiskMetrics' recommendations are more likely to affect director election results

RiskMetrics' Executive Compensation Evaluation Policy (cont'd)

RiskMetrics' Policy

On November 19, 2009, RiskMetrics published its U.S. Corporate Governance Policy 2010 Updates, which are applicable to shareholders meetings on or after February 1, 2010

The 2010 policy updates relating to executive compensation matters reorganize and update RiskMetrics' proxy voting guidelines relating to executive compensation into an integrated Executive Compensation Evaluation policy

Recommendations issued under the Executive Compensation Evaluation policy will apply, as applicable, to the following proxy items:

- Election of directors (primarily members of the compensation committee)
- Say on pay advisory votes
- Equity incentive plan proposals

RiskMetrics' Executive Compensation Evaluation Policy (cont'd)

RiskMetrics' Policy (cont'd)

RiskMetrics will recommend a vote AGAINST a management "say on pay" proposal; AGAINST/WITHHOLD on compensation committee members (or, in cases where the full board is deemed responsible, all directors); and/or AGAINST an equity incentive plan proposal if:

- There is a misalignment between CEO pay and company performance (pay for performance)
 - this evaluation will consider whether the company has underperformed (as measured by total shareholder return) relative to its peers over a sustained period of time
 - this evaluation will consider whether a company's one-year and three-year total shareholder return are in the bottom half of its industry group (the company's four-digit Global Industry Classification Code) and, if so, whether the total compensation of the CEO is aligned with the company's total shareholder return. In evaluating CEO compensation, RiskMetrics will consider:
 - whether the CEO's pay has increased or decreased and the magnitude of the change
 - the reason for the change in pay (i.e., performance vs. non-performance based elements)
 - beginning with 2010, RiskMetrics will assess the CEO's pay relative to company performance over a period of five years

RiskMetrics' Executive Compensation Evaluation Policy (cont'd)

RiskMetrics' Policy (cont'd)

- The company maintains problematic pay practices
 - RiskMetrics identifies a number of practices that are particularly contrary to a performance-based pay philosophy. The following practices generally are classified by RiskMetrics as "egregious" practices and may result in a negative vote recommendation on a standalone basis in the absence of mitigating factors:
 - employment agreements providing multi-year guaranteed salary increases, bonuses and equity awards
 - pension benefits calculated on the basis of additional years of unworked service or including long-term equity awards in the calculation
 - perquisites for former or retired executives; extraordinary relocation benefits
 - change in control payments exceeding 3 times base salary and target bonus; single trigger change in control payments; change in control agreements providing for excise tax gross-ups
 - tax reimbursements for perquisites
 - dividends or dividend equivalents paid on unvested performance shares or units
 - executives using company stock in hedging transactions
 - repricing underwater options without shareholder approval

RiskMetrics' Executive Compensation Evaluation Policy (cont'd)

RiskMetrics' Policy (cont'd)

- Additional practices that could result in a negative vote recommendation include the following:
 - incentives that may motivate excessive risk-taking such as a single metric used for short and long-term plans, without the presence of risk mitigation policies (e.g., clawbacks and stock ownership/holding)
 - recent options backdating
 - overly generous perquisites
 - internal pay disparity
 - excessive differential between CEO total pay and that of the next highest paid named executive officer
- The board exhibits poor communication and responsiveness to shareholders
 - poor disclosure practices
 - failure to respond to majority-supported shareholder proposal
 - failure to respond to significant opposition to management say on pay proposal

RiskMetrics' Executive Compensation Evaluation Policy (cont'd)

RiskMetrics' Policy (cont'd)

- RiskMetrics provides a voting hierarchy which indicates that a management say-on-pay proposal is the primary focus of voting on executive pay practices
 - in cases where there is a management say-on-pay proposal, RiskMetrics may recommend an AGAINST vote on the advisory proposal where the company has a problematic executive pay practice (i.e., misalignment between CEO pay and company performance; egregious pay practice; poor compensation disclosure or board responsiveness); in addition, in such cases where there is a management say on pay proposal, RiskMetrics may recommend an AGAINST/WITHHOLD vote on compensation committee members (or, if the full board is deemed accountable, for all directors) in egregious cases
 - in cases where there is no management say-on-pay proposal or in cases where the board has failed to respond to concerns raised by a prior management say-on-pay proposal, RiskMetrics will recommend an AGAINST/WITHHOLD vote where the company has a problematic executive pay practice.
 - where the negative factors relate to an equity incentive plan proposal, RiskMetrics may recommend an AGAINST vote

RiskMetrics' Executive Compensation Evaluation Policy (cont'd)

RiskMetrics' Policy (cont'd)

- In addition, RiskMetrics' evaluation of the following specific matters may result in an AGAINST vote on a management say-on-pay proposal:
 - performance metrics in short-term and long-term plans, principally whether the goals are sufficiently challenging in relation to payout levels
 - peer group benchmarking used to set target pay or award opportunities, principally whether the peer companies are appropriate and whether target pay is above median
 - balance of performance-based versus non-performance-based pay for the CEO. Note that stock options (which are not performance vested) and service-based restricted stock are not treated as performance-based compensation for this evaluation

RiskMetrics' Executive Compensation Evaluation Policy (cont'd)

RiskMetrics' Policy (cont'd)

- RiskMetrics has maintained its policies on equity incentive plan proposals, where it will recommend an AGAINST vote if any of the following factors apply:
 - the total cost (measured by shareholder value transfer) of the plan is unreasonable
 - the plan expressly permits repricing without shareholder approval
 - there is a disconnect between CEO pay and company performance (where there is an increase in CEO compensation where more than 50% is attributable to equity awards)
 - the company's three year burn rate exceeds the greater of 2% or the mean plus one standard deviation of its industry group
 - the plan provides for vesting acceleration even though an actual change of control may not occur
 - the plan is a vehicle for problematic pay practices

CD&A – Review and Update

Compensation Discussion and Analysis (CD&A)

- CD&A requires disclosure of the company's compensation program and policies for executives
- Part of SEC rule changes adopted in 2006 and effective for 2007 proxy season
- Continuing SEC dissatisfaction with clarity and content of disclosures
 - SEC will discontinue issuing “futures” comments in cases where the Staff’s position is clear (e.g., disclosure of performance targets), and will require that companies amend their SEC filings
- May see elements of compensation risk assessment migrate into CD&A, including:
 - how compensation policies align with risk and risk management
 - how compensation policies align with long-term value creation
 - what specific policies does the company have to mitigate risk in compensation
 - if risk is material element of compensation policies, discussion of risk is required for CD&A

CD&A – Review and Update (cont'd)

Compensation Discussion and Analysis (CD&A) (cont'd)

- Following areas will continue to be areas where the SEC will expect better disclosure in the CD&A:
 - analysis as to "how" and "why" the amount and mix of compensation was paid
 - analysis of how any performance targets were set
 - analysis of how compensation is linked to performance
 - analysis of how and why peer companies were chosen for benchmarking
 - analysis of how and why change of control payment provisions were determined
 - analysis of how and why deferred compensation arrangements were determined
 - analysis of any internal pay equity
 - analysis of cost to company of compensation that doesn't qualify as performance-based under IRC Section 162(m)
 - analysis of cost to company and benefit to executives of tax gross-ups
- CD&A will become "sales piece" for any "say-on-pay" proposal
- For companies with significant retail investor base, will become more important to provide clear disclosure with executive summary

Unintended Consequences?*

In the past, legislation and regulations adopted to address perceived excesses in executive compensation often produced unintended consequences

- Sections 280G and 4999 of the IRC limiting deductibility of golden parachutes and imposing excise taxes on excessive golden parachutes resulted in (i) a standard benchmark of 2.99X base compensation for change of control severance agreements and (ii) tax gross-ups for excess parachute payments
- Section 162(m) of the IRC limits deductible compensation to \$1 million for certain proxy named executive officers, other than in cases of "performance-based compensation." This resulted in (i) the \$1 million figure becoming a benchmark for base compensation, (ii) increased use of stock options, (iii) proliferation of "performance-based" plans and (iv) increased use of deferred compensation, all of which escalated executive compensation
 - with the current focus on the relationship between compensation and risk, many "best practice" guidelines favor the use of Compensation Committee discretion in incentive plans to mitigate against risk and less use of options which are considered to promote risk and short-termism, a 180-degree turn from 162(m)

* The law of unintended consequences holds that any purposeful action will produce one or more unintended, unanticipated and usually unwanted consequences, which may be more significant than the intended effect.

Unintended Consequences? (cont'd)

- 1992 and 2006 SEC changes in executive compensation disclosure requirements resulted in greater transparency of executive compensation, including benchmarking disclosure, but created a positive feedback loop resulting in increased executive compensation; also, while intended to produce transparency, really resulted in disclosure fatigue and obfuscation
- Some commenters believe that annual "say-on-pay" votes will result in less meaningful review of companies' compensation practices, more boilerplate disclosures, undue influence of proxy advisors such as RiskMetrics, and less critical review by Boards and management who can point to positive say-on-pay votes as an endorsement of their practices
- Remains to be seen whether SEC enhanced proxy compensation disclosure requirements will have unintended consequences

Unintended Consequences? (cont'd)

- Will increased deferred stock-based compensation for executives at financial institutions like Goldman Sachs and Morgan Stanley produce the intended consequences?
 - if stock price decreases, will companies need to true up the compensation?
 - with a greater portion of compensation at risk, will ultimate payout amounts turn out to be greater?
 - will talent leave?
- Arguably, market forces should be allowed to self-regulate executive compensation
 - has the SEC become more politicized in the area of executive compensation?
- In addition, significant changes in corporate governance have resulted in greater director oversight of executive compensation
 - majority of independent directors
 - independent director composition of Compensation Committees
 - already enhanced disclosure resulting in greater transparency of executive compensation
 - gaining prevalence of majority voting for directors
 - shareholder approval of equity compensation plans
 - influence of RiskMetrics
 - influence of institutional investors

Unintended Consequences? (cont'd)

- Directors are also mindful of:
 - litigation risk
 - increasing occurrence of lawsuits claiming waste and breach of fiduciary duty relating to executive compensation matters
 - potential for reputational damage
- On the other hand, Boards are justifiably concerned about retention of executive talent and are mindful that compensation costs are relatively immaterial in relation to revenues and expenses

Key Takeaways

Key best practices to implement include the following:

- Compensation Committee to directly engage independent compensation consultant
- Compensation Committee should consider assessing the independence of its compensation consultant and consider including disclosure of the consultant's independence in the proxy statement
- Compensation Committee should review tally sheets and compensation outcomes under different scenarios
- Risk analysis
 - risk management personnel should be involved to identify and help measure risks and analyze risk outcomes
 - Compensation Committee should consider design changes in compensation programs to better align such programs with the company's strategic tolerance of risk
- Adopt practices that mitigate risk
 - clawback policies
 - bonus banking
 - hold 'til or through retirement
 - stock ownership requirements
 - longer vesting periods

Key Takeaways (cont'd)

Key best practices to implement include the following: (cont'd)

- More appropriate benchmarking and rigorous assessment of criteria for peer companies
- Adopt balanced compensation program that is designed to reward long-term value creation and be aligned with long-term business objectives
 - performance measures
 - justification for performance measures
 - use of relative vs. absolute measures
 - Mix of short and long-term compensation
 - shift mix to greater percentage of performance based restricted stock vs. time vested restricted stock
 - shift mix to greater emphasis on longer-term incentives
- Eliminate poor pay practices such as inappropriate perquisites, gross-ups, golden parachutes, SERPs and deferred compensation arrangements
 - “fixes” to comply with RiskMetrics policies
- Transparent and understandable compensation disclosures
 - increasingly important with impending adoption of "say-on-pay" advisory vote

Key Takeaways (cont'd)

Are companies changing their compensation practices?

- Changes have been implemented by financial institutions that have been subject to TARP and post-TARP scrutiny
- Companies have implemented risk assessments in anticipation of complying with the enhanced proxy disclosure rules
- A number of companies have implemented the following changes:
 - adopted clawback policies
 - adopted stock ownership policies
 - adopted hold 'til or through retirement policies
 - eliminated tax gross-ups
 - amended or eliminated golden parachutes

Key Takeaways (cont'd)

What's next?

- SEC believes that the new proxy disclosure rules are insufficient by themselves and that only with proxy access will investors be better equipped to hold directors accountable for their compensation decisions and risk oversight
- Say-on-Pay
- Additional legislative reforms:
 - enhanced independence requirements for Compensation Committee members
 - independence requirements for compensation consultants and advisers
 - additional governance requirements – e.g., annual director elections, majority vote
 - additional compensation requirements – e.g., clawback policies
- Institutional shareholders will exert increasing pressures on companies to adopt best practices
- Companies likely to closely re-examine their compensation programs and their disclosures for the 2010 proxy season, particularly with the impending adoption of say-on-pay for the 2011 proxy season
- Is focus on executive compensation the best use of legislative, regulatory and company resources?

APPENDIX A

2009 Say-On-Pay Proposals

- Among the companies receiving “Say-on-Pay” shareholder proposals in 2009 are the following:

Abbott Laboratories (ABT)
Alaska Air (ALK)
Allegheny Energy (AYE)
Allstate (ALL)
Altria Group (MO)
American Express (AXP) *
American International Group (AIG)
Ameriprise Financial, Inc. (AMP)
Apple Computer (APL)
Applied Micro Circuits Corporation (AMCC)
AT&T (T)
Bank of America (BAC)
Bank of New York Mellon (BK)
Boeing (BA)
Bristol Myers Squibb (BMY)
Burlington Northern Santa Fe (BNI)
Capital One Financial (COF)
CenturyTel (CTL)
Charming Shoppes (CHRS)*
Chevron (CVX)
Cisco Systems, Inc. (CSCO)
Citigroup (C)
Citizens Communications (CZN)
(now Frontier Communications (FTR))
CoBiz Financial (COBZ)
Coca-Cola Company (KO)
Colgate-Palmolive (CL)
Comcast (CMCSA)
Commonwealth Bankshares, Inc.
ConocoPhillips (COP)
CVS / Caremark (CVS)
Deere & Company (DE)
Dominion Resources (D)

Dupont (E.I. du Pont de Nemours) (DD)
Edison International (EIX)
Electronic Data Systems (EDS)
Eli Lilly (LLY)
Embarq (EQ)
EMC (EMC)
Entergy (ETR)
Exxon Mobil (XOM)
FedEx Corporation (FDX)
Ford (F)
Freeport-McMoRan Cooper & Gold (FCX)
General Electric (GE)
General Mills, Inc. (GIS)
General Motors (GM)
Goldman Sachs (GS)
Hain Celestial Group (HAIN)
Hewlett-Packard (HPQ) *
Honeywell (HON)
Huntington Bancshares (HBAN)
Intel (INTC) *
International Business Machines (IBM)
Johnson & Johnson (JNJ)
Jones Apparel Group (JNY)
KB Home (KBH)
Lexmark International (LXK)
Lockheed Martin (LMT)
Marathon Oil (MRO)
McDonald's (MCD)
Merck (MRK)
Morgan Stanley (MS)
Northrop Grumman (NOC)
Occidental Petroleum (OXY) *
Oracle (ORCL)

PepsiCo (PEP)
Pfizer (PFE)
PG&E (PCG)
Plum Creek Timber Company, Inc. (PCL)
Procter & Gamble (PG)
Prudential (PRU)
Pulte Homes (PHM)
Questar Corporation (STR)
Qwest (Q)
Raytheon (RTN)
Rite Aid (RAD)
Schering-Plough (SGP)
Schlumberger Limited (SLB)
Sempra Energy (SRE)
South Financial Group (TSFG)
State Street (STT)
Target (TGT)
The Ryland Group, Inc. (RYL)
Time Warner (TWX)
TW Telecom Inc. (TWTC)
Tupperware Brands (TUP)
UnitedHealth (UNH)
Valero Energy (VLO)
Wachovia (WB)
Waddell & Reed Financial (WDR)
Wal-Mart Stores (WMT)
Walt Disney Company (DIS)
Wells Fargo & Company (WFC)
XTO Energy Inc. (XTO)
Yahoo (YHOO)
YUM! Brands (YUM)
Zions Bancorporation (ZION)

* - resolution withdrawn in light of agreement

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