Executive Compensation in 2010 – What Lies Ahead

While 2009 certainly brought its share of activity on the executive compensation and corporate governance fronts, 2010 promises to be even busier – new proxy disclosure rules, the first proxy season without broker discretionary voting in uncontested director elections, the likely adoption of a mandatory "Say on Pay" requirement, an SEC proposal on proxy access – on top of pending federal legislation to reform executive pay and corporate governance and heightened investor scrutiny.

To assist with your 2010 planning, we summarize the current status of the key issues that may affect your executive compensation program this year and beyond.

Proxy Disclosure Enhancements

On December 16, 2009, the SEC adopted several changes to its proxy disclosure rules that are effective for the 2010 proxy season. In the compensation area, these changes include:

- a discussion of a company's compensation policies and practices for all employees (not just executive officers) if they create risks that are reasonably likely to have a material adverse effect on the company;
- the reporting of the aggregate grant date fair value of equity awards in the Summary Compensation Table and Director Compensation Table; and
- explicit fee disclosure where a consultant that advises on executive or director compensation also provides additional services to a company.

In the corporate governance area, these changes include:

- enhanced disclosure of the particular experience, qualifications, attributes, and skills of directors and director nominees, as well as their past service as a public company director and involvement in a broad range of legal proceedings;
- disclosure of whether, and if so how, a board nominating committee considers diversity in identifying director nominees;
- a description of a company's board leadership structure (whether the company combines or separates the chief executive officer and board chair positions), including an explanation of why its structure is appropriate; and
- disclosure of the extent of the board of directors' role in the risk oversight of the company.

These changes are effective February 28, 2010, and generally apply to public companies with fiscal years ending on or after December 20, 2009.

For additional information on these new proxy disclosure requirements, see our Thoughtful Pay Alert, SEC Adopts Proxy Disclosure Enhancements in Time for 2010 Proxy Season (December 16, 2009) »

Risk Disclosure

Although it appears unlikely that most companies will conclude that the risk aspects of their compensation policies and practices are likely to have a material adverse impact, it is expected that, given its heightened prominence, many companies will elect to address risk as part of their executive compensation disclosure. This disclosure should cover two areas: affirmative acknowledgement that the board of directors, or appropriate board committee, has conducted a risk assessment and identification of the features of their compensation programs that mitigate or eliminate risk, such as compensation recovery policies and stock holding requirements. In addition, companies are still required to address risk in their Compensation Discussion and Analyses to the extent that such considerations are a material aspect of their compensation policies or decisions for their named executive officers.

Perhaps just as importantly, RiskMetrics Group, Inc. has announced that, beginning in 2010, it will consider whether

a company's incentive compensation practices may motivate inappropriate risk-taking by its executives as part of its evaluation of "problematic pay practices." In this regard, RiskMetrics has indicated that compensation policies and practices that could potentially encourage excessive risk-taking include:

- Guaranteed bonuses;
- The use of a single performance metric for short-term or long-term incentive compensation plans;
- Lucrative severance packages;
- High pay opportunities relative to industry peers;
- Disproportionately large supplemental pensions; and
- "Mega annual" equity awards that provide unlimited upside with no downside risk.

This assessment will also consider the extent to which program features, such as clawback policies or stock ownership and holding requirements, may mitigate potential risks.

Consequently, in preparing its executive compensation disclosure, a company should identify any program features that could potentially be viewed by RiskMetrics as creating "excessive risk" and be prepared to address this issue in its Compensation Discussion and Analysis.

For additional information on RiskMetrics' policy updates for the 2010 proxy season, see our Thoughtful Pay Alert, RiskMetrics Issues Policy Updates for 2010 Proxy Season (December 4, 2009) »

"Say on Pay"

Although in January 2009 it was almost universally accepted that a mandatory advisory vote on executive compensation requirement would be adopted before year end, it did not happen. Nonetheless, a legislatively-mandated "Say on Pay" requirement is widely expected in 2010. While not certain, it is likely that any new "Say on Pay" vote will not go into effect until 2011, at the earliest.

In December, the House of Representatives approved H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, which contains "Say on Pay" rules that would apply to all domestic public companies. This bill effectively incorporates in total the "Say on Pay" provisions of H.R. 3269, which was approved by the House in July 2009. While the Senate has yet to act on financial services reform legislation, the draft bill currently under discussion, the Restoring American Financial Stability Act of 2009, contains its own "Say on Pay" provisions. In addition, several other bills, including S. 1074, the Shareholder Bill of Rights Act of 2009, that would create a mandatory "Say on Pay" requirement are pending in the Senate.

As proposed, these bills would create two separate "Say on Pay" requirements: an annual non-binding advisory vote on a company's executive compensation program as disclosed in its proxy statement (the Compensation Discussion and Analysis and related compensation tables) and a non-binding advisory vote on any "golden parachute" arrangements implemented in connection with a merger, acquisition, or other corporate transaction (to the extent not previously subject to the annual advisory vote).

While the bills contemplate an annual "Say on Pay" vote, in recent months companies have begun to voluntarily adopt advisory vote policies that call for a less frequent vote. In 2009, Microsoft adopted a triennial advisory vote requirement, while Pfizer and Prudential Financial announced that they intend to hold biennial advisory votes. It remains to be seen whether this development will have any impact on Congressional deliberations.

For additional information on the "Say on Pay" movement and advisory votes on executive compensation, see our Thoughtful Pay Alert, Shareholder Advisory Votes on Executive Compensation – A "Say on Pay" Primer (June 12, 2009) »

Compensation Committee Independence

To reinforce the primacy of the board compensation committee in overseeing executive compensation, H.R. 4173 contains a series of proposals designed to ensure compensation committee independence, including requirements that:

- each member of the compensation committee be "independent," based on standards similar to those applicable to audit committee members;
- a compensation committee only use compensation consultants and other similar advisors that meet "independence" standards established by the SEC;
- the compensation committee be directly responsible for hiring, compensating, and overseeing the compensation consultant;

- the compensation committee have authority to engage independent legal counsel;
- the compensation committee receive from the company the necessary funding to engage compensation consultants and other advisors; and
- companies disclose whether the compensation committee obtained advice of an independent compensation consultant.

The Restoring American Financial Stability Act, the Senate's draft financial services reform bill, contains comparable provisions. Although it's uncertain whether the proposals will survive in the final version of any comprehensive financial services reform legislation enacted later this year, it's unlikely that any new requirements will go into effect before 2011, at the earliest.

For additional information on the ongoing debate on compensation consultant independence, see our Thoughtful Pay Alert, Compensation Consultant Conflicts in the Spotlight in 2010 (September 18, 2009) »

Executive Compensation Legislative Proposals

In addition to its "Say on Pay" and compensation consultant independence provisions, the Senate's proposed financial services reform legislation, the Restoring American Financial Stability Act, contains several additional provisions aimed at reforming executive compensation practices. These include requirements that:

- companies disclose the relationship between executive compensation and their financial performance, using a pictorial comparison of executive compensation levels and their company's financial performance over the preceding five years;
- companies develop and implement a compensation recovery ("clawback") policy that would (i) be triggered by a financial restatement, (ii) cover all executive officers, and (iii) require recovery of all incentive-based compensation (including stock options) from the executive officers (both current and former) for the three year period preceding the restatement in excess of what they would have been paid under the restatement; and
- the SEC adopt rules requiring proxy disclosure of whether a company permits its employees to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset market declines affecting compensatory equity awards.

Other bills that have been introduced in Congress, including S. 1074, the Shareholder Bill of Rights Act of 2009, and H.R. 2861, the Shareholder Empowerment Act of 2009, contain comparable proposals. As with the "Say on Pay" and compensation consultant independence provisions, it's uncertain whether any of these proposals will survive in the final version of any comprehensive financial services reform legislation enacted later this year, or otherwise be enacted.

Broker Discretionary Voting

On July 1, 2009, the SEC approved an amendment to New York Stock Exchange Rule 452, eliminating the ability of brokers to exercise their discretion to vote uninstructed shares held in "street name" accounts in uncontested director elections. This change is effective January 1, 2010.

As a result, beginning with the 2010 proxy season the number of shares voted in director elections will be lower than in previous years. Companies that are likely to be immediately affected by this change include companies with a majority voting standard for the election of directors and companies with significant retail shareholder bases.

Companies will also need to include at least one "routine" matter (such as the ratification of auditors) on their annual shareholder meeting agenda to ensure a quorum for state corporate law purposes (since Rule 452 permits brokers to engage in discretionary voting of uninstructed shares on "routine" matters). Companies that have moved to the electronic delivery of their proxy materials may also experience difficulties in satisfying quorum requirements due to the decline in shareholder participation that has followed such a move.

This rule change is likely to increase the influence of institutional shareholders in director elections as their votes make up a greater portion of the votes cast. In addition, election outcomes will be more sensitive to the voting recommendations of the major proxy advisory firms, such as RiskMet-

rics Group, Inc. and Glass Lewis & Co., who either advise, or vote outright on behalf of, their institutional clients.

Director Accountability – Proxy Access

On May 20, 2009, the SEC proposed significant changes to its proxy rules that would enable large shareholders to nominate director candidates for a company's board of directors using the company's proxy materials. This controversial initiative consists of two specific proposals:

- a change to existing rules that would enable shareholders, subject to certain specified conditions, to offer proposals on director nomination procedures; and
- a new rule that would permit large shareholders (or groups of shareholders) to nominate one or more director candidates using a company's proxy materials under certain specified conditions.

Although the SEC initially intended to finalize these proposals before the end of 2009, it has deferred action until early 2010. Consequently, the final rules, regardless of their content, will not be in place for the traditional 2010 proxy season.

At this point, while it is generally accepted that some form of proxy access will be adopted, it remains to be seen whether one or both of the original proposals will be approved, or the SEC, instead, will move in a different direction.

For additional information on the ongoing movement towards greater director accountability, see our Thoughtful Pay Alert, Director Accountability in the Spotlight (June 12, 2009) »

Director Accountability – Legislative Proposals

In addition to its executive compensation reforms, the Senate's proposed financial services reform legislation, the Restoring American Financial Stability Act, contains several additional provisions aimed at increasing director accountability. These include requirements that:

- all public companies adopt a majority voting standard in uncontested director elections;
- the SEC adopt proxy access rules, under which shareholders would be permitted to nominate directors using the company's proxy materials on terms to be determined by the SEC;
- companies disclose in their proxy statements why they have chosen to combine or separate the positions of chief executive officer and board chair; and
- would prohibit staggered (or "classified") boards of directors unless expressly adopted or ratified by a company's shareholders.

Other bills that have been introduced in Congress, including S. 1074, the Shareholder Bill of Rights Act of 2009 and H.R. 2861, the Shareholder Empowerment Act of 2009, contain comparable proposals. As with the proposed executive compensation reforms, it's uncertain whether any of these proposals will survive in the final version of any comprehensive financial services reform legislation enacted later this year, or otherwise be enacted.

Shareholder Voting Results

Effective February 28, 2010, the SEC will require that public companies report the voting results from their annual shareholder meetings on a current report on Form 8-K within four business days after the end of the meeting. This replaces the former requirement to disclose voting results in either annual or quarterly reports, which can be filed well after the relevant meeting. In situations where it isn't possible to determine final voting results within the four-day filing period, a company is required to file its preliminary voting results within four days after the end of the shareholder' meeting, and then file an amended Form 8-K within four business days after the final voting results are known.

Need Assistance?

Compensia has had significant experience in helping companies to design and implement their executive compensation programs. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance in assessing their likely impact on your executive compensation plans and arrangements, please feel free to contact us. ■

About Compensia

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