

THE PERFECT STORM SWIRLING AROUND EXECUTIVE COMPENSATION AND THE RELATED CORPORATE GOVERNANCE

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The Evolution of the Regulation of Executive Compensation

When the financial crisis began in 2008, an outcry came again regarding executive compensation and incentive compensation. The outcry over the incentive and executive compensation led to a new group of legislative and regulatory changes that are the next step in a longer series of changes over the last twenty-five years during which the regulation of executive compensation has evolved. The SEC made regulatory changes to executive compensation disclosure and/or governance in 1992, 2006 and most recently through the proposed rules published in the Federal Register on July 17, 2009¹

The Internal Revenue Service entered the regulation of executive compensation first when Congress enacted the golden parachute provisions in the Tax Reform Act of 1984² and again when Congress added the \$1 million cap on the deductibility of non-performance based compensation in 1993 in Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"). Following Enron and the related market collapse from the dot.com era, Congress again acted against perceived abuses and added Code section 409A regulating nonqualified deferred compensation which was adopted in 2004 in the American Jobs Creation Act of 2004.³ The Internal Revenue Service further completed the picture by issuing the final regulations on Code section 409A which became effective January 1, 2008 and required amendments by December 31, 2008.⁴

In addition to the government's regulation, the Financial Accounting Standard Board issued Statement 123(R) in 2006 requiring companies to estimate the amortized expenses of stock options on their income statements and has continued to regulate the disclosure of post-retirement medical and other benefit obligations under FASB Statement 158. All these measures are ways in which executive compensation has been subject to increasing regulation and disclosure requirements.

¹ 74 Fed. Reg. 35706.

² P.L. 98-369.

³ P.L. 108-357.

⁴ 72 Fed. Reg. 19234 (April 17, 2007).

Risks, Rewards and the Regulatory Response to the Financial Crisis

In response to concerns that the 2008 financial industry instability was driven by inappropriate incentive compensation, the Emergency Economic Stabilization Act of 2008 (“EESA”)⁵ and the American Recovery and Reinvestment Act of 2009 (“ARRA”)⁶ both regulated executive compensation provided by entities in the financial industry that were receiving public bail out funds. Both EESA and ARRA regulated executive compensation of financial institutions, but did not attempt to regulate executive compensation outside of the financial institution arena.

Additional Legislative Proposals

A number of legislative efforts to address the perceived evils of executive compensation and perceived gaps in corporate governance were introduced in Congress in 2009. Some bills to regulate executive compensation were introduced in the House and others in the Senate in 2009. This article discusses two of the more prominent legislative proposals. The Corporate and Financial Institution Compensation Fairness Act of 2009⁷ passed the House of Representatives on July 31, 2009 and is pending in the Senate Committee on Banking, Housing and Urban Affairs. The Shareholder Bill of Rights Act of 2009, S. 1074 is also pending in the same Senate committee. While both bills carry names intended to convey that they intend to improve fairness and governance, the bills must be examined in light of existing regulations and listing requirements to determine if they truly make significant changes.

S. 1074- the Shareholder Bill of Rights Act of 2009

Senator Schumer introduced S. 1074 which provides for an annual shareholders “say on pay” with respect to executive compensation and for a “say-on-pay” on compensation based upon a “change in control,” 1% shareholder input into nominations for annual board elections, and mandatory changes in corporate governance standards in order for a company to remain listed on an exchange.

S. 1074 requires majority voting for election of a director in an uncontested election. If the director is not elected by majority of votes, the director shall tender his or her resignation to the board of directors and the board shall accept the resignation and determine the date it is effective and make that date public within a reasonable period of time. If the director election is contested and there are more nominees than positions, then the director must be elected by a plurality of the votes of the shares represented at the meeting and entitled to vote in a contested election. There is no explanation of what must occur if there are not sufficient directors receiving a plurality of votes to fill all of the open board positions. S. 1074 requires the board of directors to accept the resignation of a director who is not successful in an uncontested election, determine when the resignation will be effective and make such date public within a reasonable

⁵ P.L. 110-343

⁶ P.L. 111-5.

⁷ H.R. 3269.

period of time. This is a significant change from the current practice as evidenced in the Wall Street Journal article on September 28, 2009, entitled “*Directors Lose Elections, but Not Seats,*”⁸ which reported that of the directors that were not elected by majority vote in the last year, all of them were still serving as directors because the board rejected the resignations tendered and reappointed the directors.

S. 1074 also requires the SEC to issue a regulation mandating that listing exchanges require all listed companies have an independent board member be the chairman of the board and that such person has not previously served as an executive officer of the company.

S. 1074 mandates the SEC to require all exchanges to require all listed companies to have an annual election of every board member, eliminating staggered boards.

S. 1074 further requires that each issuer establish a risk committee comprised entirely of independent directors responsible for the establishment and evaluation of risk management practices at that company. Thus, S. 1074 includes significant corporate governance changes that will impact nomination and election of directors and corporate governance.

H.R. 3269- The Corporate and Financial Institution Compensation Fairness Act of 2009

While H.R. 3269 similarly provides the “say on pay” for both annual executive compensation and also for executive compensation in the event of a “change in control,” it also requires that institutional investment managers report their votes on the annual “say on pay” and “golden parachute say-on-pay.” If the regulations proposed by the SEC on executive compensation disclosure and governance are adopted without change, registered companies will be required to report the result of all votes on a Form 8-K within four (4) days of the date the vote is determined.

If the annual executive compensation vote or golden parachute compensation vote is approved by the shareholders under H.R. 3269, then the amounts paid pursuant to such approved arrangements may not be subject to a clawback, except if the clawback is done in accordance with the executive’s contract, or in the case of fraud by the executive, or to the extent it is required by Federal or State law, such as when financial statements are restated under the Sarbanes-Oxley Act (“SOX”).⁹

H.R. 3269 also imposed incentive pay restrictions on financial institutions with more than \$1 billion in assets, regardless of whether the entity is publicly traded or not. The financial institutions subject to this rule are not limited to banks, but include broker-dealers, credit unions, investment advisors, federal national mortgage associations, federal home loan mortgage company, corporations and any other financial institution that the federal regulators jointly determine should be treated as covered. If enacted, H.R. 3269 would require that those

⁸ B-4.

⁹ P.L. 107-204.

institutions annually disclose to the applicable federal regulator the structure of all incentive compensation arrangements offered so the regulator can determine if such arrangements are structured to align with sound risk management, account for the time horizon of risk, and meet other criteria that the federal regulators determine to be appropriate to reduce unreasonable incentives for employees to take undue risk that could threaten the safety or soundness of the covered financial institution or could have serious adverse effects on economic conditions or financial stability. The actual compensation of the individuals is not required to be disclosed, only the incentive arrangement must be disclosed to the federal regulators. The incentive arrangements required to be disclosed for approval by the federal regulators are not limited to executive compensation.

Risk is generally addressed in the audit committee, not the compensation committee. The compensation committees of these financial institutions will need to develop expertise in risk analysis or develop a means by which they can access and utilize the audit committee's risk analysis experience to be able to address this proposed legislative change and the proposed disclosure changes in the SEC proposed regulations on executive compensation disclosure and governance discussed below.

H.R. 3269 requires the SEC to issue a regulation requiring the national securities exchanges and associations to prohibit listing of a company unless the compensation committee meets certain requirements. Many of the statutory requirements track statutory requirements that are currently applicable to audit committee under SOX. The legislation in effect would impose by statute some of the independence requirements that are currently imposed by the NASDAQ and NYSE.¹⁰ However, many of the independence requirements in H.R. 3269 are not as detailed as the current independence requirements in the NYSE listed company manual or in the NASDAQ listed company manual for the independence of compensation committee members.¹¹

The compensation committee changes in H.R. 3269 require each member of the compensation committee to be independent. That means they may not, other than in the capacity as a compensation committee member, member of board of directors or other board committee, accept any consulting, advisory or other compensatory fee from the issuer. This language tracks the audit committee's statutory requirements in SOX, but it does not include the audit committee's statutory prohibition that each of the audit committee's directors not be an "affiliated person" of the issuer or subsidiary thereof found in 15 U.S.C. § 78j-1(m)(3)(B)(ii). The SEC can exempt a particular relationship of a compensation committee member if the SEC determines it is appropriate. The exemptive authority parallels statutory provisions for exemptive authority for the audit committee. The compensation committee is defined as a committee or equivalent body established among the board of directors for purposes of

¹⁰ See Section 3, of the NYSE Listing Manual, § 303A.02 for Independence Tests for Directors, and § 303A.05 for Compensation Committee Standards; NASDAQ Listing Rules §§ 5605 and 5605(a)(2) regarding Board of Directors and Committees and standard for "Independent Director" and IM-5605-5(d) and IM 5605-6 regarding Independent Directors and Oversight of Executive Compensation.

¹¹ Id.

determining and approving compensation arrangements for executive officers. If no compensation committee exists, independent members of the entire board of director would be treated as the compensation committee. This adds the definition of the compensation committee and there is no comparable provision with respect to the statutory provisions for the audit committee. H.R. 3269 adds statutory independence standards for the compensation committee, compensation consultants and similar advisors. The audit committee statute does not have similar provisions under SOX regarding consultants, but the auditors are prohibited by statute from providing other services under 15 U.S.C. § 78j-1(g) and the listing standards prohibit auditors from providing more than \$120,000 of other services.

The compensation consultant or similar advisor would be required to meet independence standards to be set by the SEC in regulations under H.R. 3269. This may require changes to the compensation committee charter or board questionnaire to reflect the new requirements for membership and changes to the nominating or governance committee considerations for selection of its nominees for the compensation committee.

H.R. 3269 grants the compensation committee the authority to retain independent counsel and other advisors. It also has the sole discretion and authority to select, retain and obtain advice of independent compensation consultants and other advisors. It does not require the compensation committee to act or implement any advice of these consultants or other advisors and does not affect the compensation committee's ability to reject a recommendation. The directors comprising the compensation committees are already required to be independent under the exchange listing rules. Thus, there may not be as many changes required with respect to compensation committee charter changes and many compensation committees already have resources allocated to support the compensation committee's ability to retain outside compensation consultants or advisors. However, if H.R. 3269 is enacted and the implementing regulations are issued, the compensation committee charter and operation and the board questionnaires should be reviewed to determine whether all independence issues are addressed. If H.R. 3269 is enacted, it proposes to require the compensation committee to disclose in the annual proxy whether it obtained the advice of a compensation consultant. However, it is unclear how this changes the current disclosure requirements under §229.407(e)(3)(iii) particularly if the expanded disclosures in the proposed regulation on executive compensation is adopted without change.

H.R. 3269 also provides the compensation committee with the authority to engage independent counsel and other advisors. While many compensation committees already retain their own counsel and were provided funding for such counsel, H.R. 3269 requires the company to provide appropriate funding for the compensation committee to retain compensation consultants, independent counsel and advisors. The counsel and advisors are to be independent under the standards to be set by the SEC.

H.R. 3269, if enacted, would apply to the first proxy or consent for an annual meeting that occurs one year after an enactment, or the 2011 proxy season, assuming enactment in 2009, there must be a disclosure of whether the compensation committee retained and obtained the advice of an independent consultant that met the required standards for independence. The compensation committee is also required to have the authority to engage independent counsel and other advisors in its sole discretion.

H.R. 3269 may require additional risk committees and disclosure or interaction between the current compensation and audit committees on risk analysis and management for financial institutions. However, before the legislative changes are enacted and effective, the SEC has proposed changes to address risk management and their perceived need for corporate governance changes for regulating executive compensation and excessive risk taking.

Proposed Voting Changes

NYSE Rule 452 was amended to preclude brokers from voting of shares that do not provide instruction on votes in proportion to the votes on instructed shares.¹² This change is expected to cause more uncertainty in annual elections and in proxy solicitations for votes on transactions requiring a majority vote. Thus, this loss of the broker vote on uninstructed shares coupled with the proposed increased disclosure, the say-on-pay and say-on-pay for change in control legislative proposals may make proxy seasons in the future more challenging for management. It may make it more difficult to achieve a “quorum” if no “routine” items are on the agenda.

SEC’s Proposed Executive Compensation Disclosure and Governance Regulations.

Proposed Shareholder Proxy Access Regulation

In addition to the proposed Executive Compensation disclosure and governance regulations, there were also proposed Proxy Access Rules by the SEC permitting shareholders with a 1% interest to nominate directors for inclusion on the company’s proxy material,¹³ there have been other changes that coupled with the proxy access rule, if adopted, will change the proxy seasons after 2010. The proposed proxy access regulations would expand shareholder access to proxies to permit shareholders to aggregate their holdings to meet the 1% threshold and permits the shareholders to present nominees for inclusion in the company’s proxy materials at the proxy issuer’s cost. Under the proposed regulation the greater of one or up to 25% of the entire board nominees can be filled by shareholder nominees for the board. The nominees from the shareholders are included in the proxy on a first nominated basis. The ownership of the nominator is not considered in determining which nominees are included. The nominator must have held a 1% interest for one year at the time of the nomination, but the proposal did not require the ownership to continue. There is also no requirement the nominee be independent

¹² SEC Release No. 34-60215, File SR-NYSE 2006-92, (July 1, 2009), 74 Fed. Reg. 33293 (July 10, 2009).

¹³ 74 Fed. Reg. 29024 (June 18, 2009).

from the nominator.¹⁴ The SEC announced on October 2, 2009 that it was not going to act on this proposed regulation until 2010 due to the number of comments received.¹⁵ Query: is the delay also being utilized to permit S. 1074's provision on shareholder proxy access and other changes to the election of board members to be enacted by Congress?

New Division of Corporate Finance Staff Legal Bulletin No. 14E(CF)¹⁶ on Shareholder Proposals

On October 27, 2009, the Division of Corporate Finance of the SEC (the "Division") issued its views on how certain shareholder proposals should now be analyzed to determine if they can be excluded from the proxy materials in Staff Legal Bulletin No. 14E (CF) (the "Bulletin"). The new analytical frameworks in the Bulletin are just the Division's views and have not been approved by the SEC. The Bulletin focuses on two types of shareholder proposals risk and CEO succession planning.

Previously shareholder proposals on risk were analyzed to determine if the proposal as a whole related to the company engaging in an evaluation of risk, which is a matter the Division had viewed as relating to a company's ordinary business operations. Previously to the extent a proposal had focused on a company engaging in an internal assessment of risks and liabilities the company faced as a result of operations, the Division had permitted exclusion of such proposals from the proxy under Rule 14a-8(i)(7). The Division in the Bulletin now indicates that instead of focusing on the subject matter to which the risk pertains or that gives rise to the risk, the fact that an evaluation of risk is involved will not be dispositive in determining if the proposal can be excluded. Instead, an analysis similar to the way that proposals asking "for the preparation of a report, the formation of a committee or the inclusion of a disclosure in a Commission-prescribed document – where we look to the underlying subject matter of the report, committee or disclosure to determine whether the proposal relates to ordinary business to the company. In those cases in which a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote, the proposal generally will not be excludable under Rule 14a-8(i)(7) as long as a sufficient nexus exists between the nature of the proposal and the company. Conversely, in those cases in which a proposal's underlying subject matter involves an ordinary business matter to the company, the proposal generally will be excludable under Rule 14a-8(i)(7)."¹⁷

Previously the Division had permitted exclusion of shareholder proposals regarding CEO succession planning in reliance on Rule 14a-8(i)(7) because the proposals related to termination, hiring or promotion of employees. The Bulletin explains that recent events have shown the

¹⁴ Proposed Rule Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29024 (June 18, 2009).

¹⁵ "SEC Delays Vote on Proxy Access Proposal; Staff Reviewing Comments, Schapiro Says," BNA's Corporate Counsel Weekly, October 6, 2009.

¹⁶ Shareholder Proposals, Staff Legal Bulletin No. 14E (CF), October 27, 2009, <http://sec.gov/interps/legal/cfslb14e.htm>.

¹⁷ *Id.*

importance of this Board function to corporate governance and that the Division now recognizes that CEO succession planning is a significant policy issue regarding the governance of the corporation that transcends the day-to-day business matter of managing the workforce. The Division reconsidered its position on this type of proposal and announced in the Bulletin that they are modifying their position on such proposals and now are of the position that a company cannot rely on Rule 14a-8(i)(7) to exclude a proposal that focuses on CEO succession planning. These two position changes indicate that the 2010 proxy season may be more challenging for those preparing the proxy disclosures and preparing the corporate governance changes necessary to address the changing regulatory environment.

*Proposed Executive Compensation Disclosure and Governance Regulations*¹⁸

Additional corporate governance and disclosure requirements were issued in the proposed regulations released on July 10, 2009 and published in the Federal Register on July 17, 2009.¹⁹ The proposed rules require additional disclosures regarding directors and director nominees and their qualifications for their positions on the board and any committee. The proposed regulation also requires disclosure of litigation in which any nominee was involved within the last ten years, rather than just the last five years. The increased disclosures will also require filing on a Form 8-K within four business days of the meeting date to report the results of any election. All these proposed changes will put more pressure on nominations for directors and elections.

Proposed Governance Changes.

1. *Board Leadership.* The proposed regulations also require additional disclosure regarding the board's leadership structure, including whether it separates or combines the roles of chairman and chief executive officer, whether the company has a lead independent director, and why that structure is appropriate for the company.²⁰ This is less onerous than S. 1074 which, if enacted, would mandate separation of the chairman and chief executive officer positions as well as impose additional independence requirements on the chairman.
2. *Compensation Consultants Conflict Disclosure.* The proposed regulation changes include increased disclosure of potential conflicts of interest involving compensation consultants providing advice to the board or compensation committee regarding the executive or director compensation if that compensation consultant also provides other services to the company.²¹ The proposed regulation continues to require disclosure of the compensation committee's role in determining or recommending executive compensation. The proposed regulation excepts from the disclosure any role limited to consulting on broad based plans

¹⁸ 74 Fed. Reg. 35076 (July 17, 2009).

¹⁹ 74 Fed. Reg. 35076 (July 17, 2009).

²⁰ Proposed Regulation Change to § 229.407(h).

²¹ Proposed Regulation Change to § 229.407(e)(3)(iii).

that do not discriminate in favor of executive officers or directors and that are generally available to all salaried employees during the last fiscal year. (Apparently, consulting or broad based plans to be established in the future must be disclosed.)²² However, if a compensation consultant or other affiliate played a role in determining an amount or form of director or executive compensation and they also provided additional services to the registrant or its affiliates during the registrant's fiscal year (including consulting on broad based plans that do not discriminate in favor of executives), then the nature and extent of such additional services must be disclosed as well as the aggregate fees for the services related to the executive compensation and the aggregate fees for the other services.²³ The proposed regulation also does not expand any independence requirements to reach the extent of the rules in the listed company manuals for the respective exchanges.

3. *Board's Role in Risk Management.* An additional important disclosure is providing information regarding the board's role and the company's risk management process and the effects, if any, that this role has on the company's board leadership structure.²⁴

These proposed changes all evidence additional pressures on boards with respect to assuring qualifications of board members, the board's responsibility to govern the company and manage risk, and justify the board's and company's leadership structure. These changes will require revision of committee charters and gathering additional information on the director qualifications, skills, other board seats and prior litigation.

Proposed Executive Compensation Disclosure Changes

The executive compensation disclosures affecting the named executive officers ("NEOs") requires a reversion to the equity compensation rules originally adopted in 2006 that were changed in December 2006. The changes revert back to reporting the full aggregate FAS 123R grant date fair values of the awards in the Summary Compensation Table and Director Compensation Table. The SEC indicated this change is intended to enable the investors to better evaluate the amount of equity compensation awarded for the year and the bottom line total compensation figure and better outline the identification of the named executive officers with the company compensation disclosures. All this will not make the Summary Compensation Table and Director Compensation Table tied to the financial statements equity compensation numbers in the aggregate. The compensation tables will need to be restated just for the individuals who are current NEOs for prior years but not for individuals who are no longer NEOs but were NEOs in the prior three years.²⁵

²² *Id.*

²³ Proposed Regulation Change to § 229.407(e)(3)(iii).

²⁴ Proposed Regulation Change to § 229.407(h).

²⁵ Proposed Change to §229.402(c) and (d) for NEOs and Proposed Change to §229.402(k) for directors.

A New Disclosure Regarding Overall Compensation Policies and Risk Management.

Previously the Compensation Discussion and Analysis only addressed the compensation policies and compensation with respect to the chief executive officer, chief financial officer and the three most highly compensated executive officers (the “NEOs”). The proposed regulation expands the discussion to include not only actions taken after the end of the registrant’s last fiscal year, but to require the inclusion of disclosure of the registrant’s overall compensation program to the extent risks arising from such policies and overall compensation practices for employees generally may have a material effect on the registrant and to discuss such policies and practices as they relate to risk management. The proposed regulation indicates the analysis will require analysis of a variety of situations and provide examples of situations that may trigger disclosure.²⁶ The preamble emphasizes in its repeated use of “may” that it may have a material effect, and the policy’s affect may have material effect on the company. This implies a looser standard than the concept of reporting a contingent liability for a material loss under FAS Statement 5,²⁷ or the trigger to require an accrual for a tax position under FIN 48.²⁸

It is not clear if the use of “may” will look at only each separate compensation incentive program by individual criteria or consider the compensation package as a whole to determine if the package as a whole may have a material effect on the company. The SEC requires the disclosure to address how the compensation program relates to the registrant’s risk management. Furthermore, it stated, “to the extent that risks arising from the registrant’s compensation policies and overall actual compensation practices for employees generally may have a material affect on the registrant, discuss the registrant’s policies or practices of compensating its executives, including non-executive officers, as they relate to risk management practices and/or risk taking incentives.” While the situations requiring disclosure will vary depending on the particular registrant’s compensation policies, situations that may trigger disclosure include, among others, compensation policies: at a business unit of the company that carries a significant portion of the registrant’s risk profile; at a business unit with compensation structured significantly differently than other units within the registrants; have business units that are significantly more profitable than others within the registrant; business units where compensation expenses are a significant percentage of the unit’s revenues; and that vary significantly from the overall risk and reward structure of the registrant, such as when bonuses are awarded upon accomplishment of a task, all the income and risk to the registrant from the task extended over a significantly longer period of time. The preamble explained the purpose of this paragraph is to provide investors material information concerning how the registrant compensates and incentivizes its employees that may create risk. Rather, the registrant may need to address the general design of the registrant’s compensation policies for employees whose behavior will be most impacted by the incentives established by the policies, such as policies that relate to and affect risk-taking by employees on behalf of the registrant and the manner of its implementation, the registrant’s risk assessment or

²⁶ Proposed Change to §229.402(b)(2).

²⁷ Statement of Financial Accounting Standards No. 5- “Accounting for Contingencies” (“FAS 5”).

²⁸ FASB Interpretation No. 48- Accounting for Uncertainty in Income Taxes (“FIN 48”).

incentive considerations, how the registrant's compensation policies relate to the realization of risk resulting from the actions of employees in both the short and long term and the registrant's policies regarding adjustments to compensation policies addressing changes in the risk profile.

Risks.

Determining the Standard for Determining Whether a Compensation Policy that "may have a material effect on the registrant" and Require Disclosure

This discussion and use of "may have a material effect" implies a looser standard than the concept of a material loss under FAS Statement 5 or the trigger to require an accrual for a tax position under FIN 48, which requires an assessment of the likely success of having the company's tax position upheld. The FAS 5 standard looks to reporting of loss contingencies based upon the likeliness to occur of the claim assertion; FIN 48 looks for disclosure of tax positions and analyzes each position's likelihood of being sustained to determine whether such position must be part of the total number, and if significant, individually must be disclosed separately, using the standard if it is "reasonably possible" that the position might be reversed within 12 months. This disclosure is in the financial statements and questions have been raised regarding whether it should be disclosed in the "Contractual Obligations" table in the Management discussion and analysis. It is not clear what standard will be used to determine if a policy "may have a material effect" or whether the potential effect is to be measured on a policy by policy basis or collectively considering all incentive policies or arrangements in the aggregate.

If the disclosure of compensation policies and practices are analyzed individually with respect to whether the particular policy or practice "may have a material effect on the registrant," then it would appear this will require analysis similar to the FIN 48 analysis or FAS 5 analysis, but with a much lower standard determining if disclosure is required. There is a question if any particular policy or practice alone may rise to the level of material to the registrant. If all of the compensation policies and practices are aggregated to determine if they collectively "may have a material effect" then meeting the "material effect" trigger may be easier to achieve, but would also permit different policies to offset each other, assuming the "material effect" is only looking at a direct effect on the financial statements of the company.

Material adjustments made to the compensation policies as a result of change in the risk profile and to the extent to which the registrant monitors its compensation policies to determine whether risk management objectives are being met with respect to incentivizing its employees.

Failure to disclose a compensation policy that "may have a material effect on the registrant" may result in shareholder actions related to failure to disclose and SEC enforcement actions. Either of the above actions will have an impact on the reputation of the company and may impact the company financially. It is unclear if a risk that if not disclosed would have a material effect on the reputation of the company, its compensation committee or executives must

be disclosed or if only those policies that may have a material effect on the financial statements of the registrant must be disclosed.

If the analysis of the policies and practices is made on each individual policy separately and then the results are aggregated, this is slicing and dicing compensation decisions which are part of an overall package which may include an amount of base or more guaranteed pay that is intended to provide sufficient compensation so the individual is not inclined to take excessive risks to augment his/her compensation. Compensation decisions are generally made considering the total package and how a particular element fits within the package and isolating a decision and analyzing it out of context may not give the same answer if it is analyzed in the context of how it fits in the total compensation package.

Protecting Advice of Counsel to the Company and to the Compensation Committee

In any case, it is important to remember that claims of privilege and work product doctrine protection for the work papers for any related tax accruals related to the executive compensation this disclosure are likely to be challenged after the First Circuit's decision in *U.S. v. Textron, Inc.*²⁹ In *Textron*, the Company claimed its tax accrual work papers were prepared by lawyers and others in Textron's tax department to support its calculation of the reserves for its audited financial statements. Textron, a publicly traded company, is required to have its financial statements certified by an independent auditor and must disclose under FIN 48 its estimate of potential liability if the IRS decides to challenge its debatable tax positions in its return. The First Circuit found that those tax accrual work papers were not protected under the work product doctrine because they were not prepared "because of" litigation even though Textron claimed they were prepared because of potential litigation. The First Circuit did not believe the tax accrual work papers would not exist but for Textron's need to anticipate litigation.

Tax accrual work papers prepared to support the tax accruals related to the executive compensation may also not be protected by the "work product doctrine" protection if other Circuits follow the position of the First and Fifth Circuit with respect to work papers for backing up financial statements.³⁰ Thus, the analysis in the tax accrual work papers needs to be prepared with the expectation that it could be subject to discovery.

Will the modifications to the performance compensation to mitigate excessive risk, result in the performance compensation still qualifying as performance or incentive compensation for purposes of Code section 162(m)?

Managing risk through compensation has always proven challenging. Incentive compensation for the NEOs must provide for incentives in order for it to be deductible under

²⁹ ___ F.3d ___ (1st Cir., August 13, 2009) (No. 07-2631).

³⁰ *U.S. v. El Paso Co.*, 682 F.3d 530 (5th Cir. 1982), cert. denied, 466 U.S. 944 (1984).

Code section 162(m)³¹ as pay for performance or performance based compensation. If too many metrics are added, will the pay become more assured and lose its performance status and fail to provide an adequate incentive?

Compensation programs are designed to attract, retain and motivate employees to achieve desired goals. Business must typically and broadly be framed as achieving long term increases in total shareholder returns. Performance goals with too many short term incentives led to short term risk taking which led to some of the financial problems. A Watson Wyatt study looked at compensation practices with respect to risk of likelihood of bankruptcy and found that risk mitigators reducing the risk of bankruptcy of the company included a high proportion of long-term incentives (generally including all forms of equity compensation) and the total direct compensation mix, use of market-based metrics, high annual incentive leverage, higher level of stock options in the LTI mix, and a high proportion of variable pay in total direct compensation.³² The risk aggravators which led to a higher risk of bankruptcy or default were excessive pay opportunities related to the industry, the number of performance metrics units used, use of risk-based metrics, and high accumulated executive pension value. The risk aggravators tended to insulate the executive from performance risk in a number of ways potentially leading to overly risky investment decisions. It found that where plans incorporated a high number of performance metrics, the risk of not achieving a particular metric is diversified, thus making them more subject to manipulation by executives and again insulating the executive from risk. Thus, utilizing too many measures of performance may backfire – by reducing incentives for performance. High accumulated pension value provides an ultimate insurance against poor performance because there is a guaranteed safety net at retirement.

Using equity compensation to meet the performance criteria requirement may help to preserve the performance nature of the compensation, but it has not historically prevented the executives at the companies from taking risks that may have material ill effects on the company. In another recent study by Rudiger Fahlenbrach and Rene M. Stulz on *Bank CEO Incentives and the Credit Crisis*,³³ found that bank CEOs did not reduce their holdings in bank stock prior to or during the financial crisis and such individuals were just as negatively affected as the company's shareholders. Thus, they suffered the same substantial losses in wealth as a result of the crisis as their shareholders. Thus, the use of equity compensation as a tool to focus the executives on the long term incentives horizon did not prevent the banks from the executives or their subordinates taking excessive risks.

The fact that equity compensation did not prevent risk taking by executives in the financial institutions was also stated in Scott G. Alvarez, General Counsel at the Board of Governors of The Federal Reserve System's testimony before the Financial Services Committee in the U.S. House of Representatives on June 11, 2009 in which he stated:

³¹ Code section 162(m) was added effective three years after January 1, 1994 by P.L. 103-66.

³² Watson Wyatt, "Executive Pay and the Economic Recovery September 2009" at www.watsonwyatt.com.

³³ Dice Center for Research and Financial Economics Working Paper, 2009-13, Fisher College of Business, Ohio State University, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439859

“There are several ways that compensation can be adjusted for risk. For example, one approach involves deferring some or all of an incentive compensation award and reducing the amount ultimately paid if the earnings from the transactions or business giving rise to the award turn out to be less than had been projected. Another way to improve the risk sensitivity of compensation is to take explicit account of the risk associated with a business line or employee's activities--such as loan origination or trading activities--in the performance measures and targets that determine the amount of incentive compensation initially awarded. . . .

Firms have had some success in incorporating risk into deferred compensation, particularly for senior management, by paying performance awards in the form of company stock with multi-year vesting requirements. However, while this might be one important component of a sound incentive compensation system, stock-based compensation has not proven to be a panacea. Compensating top executives in the form of stock and deferring payouts through multi-year vesting and holding requirements did not prevent executives at some firms from permitting their firms to take on risks that endangered the firm's health and, by implication, a substantial part of the executives' own wealth. Experience suggests that it is difficult to incentivize senior managers to reduce risk by altering business practices that have been lucrative in the past or that appear to be profitable for competing firms. In addition, equity – based incentive compensation may be less effective in aligning the incentives of mid-and lower-level employees with the interests of the firm because these employees may view the outcome of their decisions as unlikely to have much effect on the firm or its stock price.”

In response to the economic crisis, the SEC has created an investment advisory group. Meredith Cross, the Director of Division of Corporate Financing from the U.S. Securities Exchange Commission in testimony before the Senate Subcommittee on Securities, Insurance and Investment of the Senate Committee on Banking, Housing and Urban Affairs on July 29, 2009 provided in her testimony that the Commission has proposed rules requiring disclosure about “how the company incentivizes its employees – beyond the named executive officers – if its compensation policies may result in material risks to the company. This disclosure is intended to enable investors to gauge whether the company's compensation policies create appropriate incentives for its employees, as opposed to creating incentives for employees to act in a way that creates risk not aligned with the risk objectives of the company.”

Much of the criticism regarding the incentive compensation fails to consider the losses the executives suffered when the market turned down as reported in an article by David Yermack a professor of finance at the New York University Stern School of Business which stated:

Consider Vikram Pandit, John Mack and Kenneth Lewis, the CEOs of Citigroup, Morgan Stanley and Bank of America, respectively. These three firms, once flagships of

American finance, all required government bailouts to stay afloat in 2008. Nevertheless, all three CEOs received several million dollars in salary and perks, an outcome that has been endlessly publicized and condemned.

That's the wrong story.

These CEOs all lost small fortunes in 2008. The 2008 compensation of Messrs. Pandit, Mack and Lewis was approximately minus \$105 million, minus \$40 million and minus \$108 million, respectively, after taking account of the losses on the stock that each CEO owned in his firm. ...

Unfortunately the political discussions of executive pay usually overlook the large gains and losses that managers earn on their prior awards of shares and options. That's where to find the real source of motivation for executives. If you stock price falls by two-thirds, as Mr. Lewis's did last year, you may lose \$100 million, as he did. The executives listed above aren't likely to make back their losses either, as four out of the six have been dismissed by their boards or have opted for early retirement (including Mr. Lewis just last week), and most CEOs unload their shares when exiting their firms.³⁴

If the incentives are restructured to emphasize individual area goals rather than enterprise goals (e.g., taxes saved by the tax department vs. company customer satisfaction), the SEC believes the compensation arrangements require closer scrutiny, but using broader enterprise goals may result in rewards for groups when the enterprise does not meet its overall goals. Changing the incentives must be considered in light of the requirements to maintain the incentive compensation as incentive or performance compensation for purposes of preserving the company's tax deduction for such compensation under section 162(m) of the Code, if the company is concerned with preserving such deduction.

Reviewing individual incentive compensation arrangements in isolation of how such arrangement fits in the total compensation package fails to consider how other features may mitigate risk taking by providing adequate base compensation.

Reviewing individual incentive compensation arrangements in isolation of the other rewards such as substantial nonqualified plan retirement income fails to consider how other elements of the total compensation program cushion the executive from losses in equity awards due to excessive risk taking. Thus, non-performance based executive compensation could provide a substantial cushion and permit the executive to take greater risks with the equity compensation he/she receives from the company.

Assuming that risk taking can be legislated or regulated is similar to believing one can impose ethics by regulation.

³⁴ "Keeping the Pay Police at Bay," by David Yermack, The Wall Street Journal, October 10-11, 2009, W-1.

“Say-on-Pay” Related Risks

If a “Say-on-Pay” vote is rendered in the negative, the board and the compensation committee must consider the impact of such vote on the company and whether the board wants to follow the current decisions or modify the current decisions regarding compensation of the NEO’s for the next year, and whether to change the currently decisions and move such individuals to a different group for purposes of the determination letter requests.

A negative vote on the compensation policy results in concerns for the compensation committee. The addition of say-on-pay, if enacted, may lead companies to consider reviewing the charter for the compensation committee and making a determination of what should be the consequences for such a no vote. For example, should the full board be asked to review the compensation policy or should the compensation committee conduct focus group meetings with major shareholders to ascertain what portion of the compensation policy is objectionable to the shareholders? A measured response appears a more rational way to address a negative vote rather than a rush to requesting a vote on each component of the compensation policy or each component by each NEO, e.g., requesting approval for base compensation to be 25% of total pay, long term cash incentives to be 35% of total pay and long term equity compensation to be 40% of pay and other benefits to comprise 5% of pay as a general policy would require shareholders to vote on components of a policy that they are not in the position to evaluate without receiving all of the comparative compensation information provided to the compensation committee by its consultants.

“Say-on-Pay for Change in Control” Related Risks

If a “Say-on-Pay” vote on a change in control is rendered in the negative, the board and the compensation committee must consider the impact of such vote on the company and the transaction. The requirement that there be a say on pay for a change in control will require the company to carefully consider the pay provided on a change in control and how it will be presented in the disclosures to the shareholders for the vote.

A negative vote on the say-on-pay for a change in control could result in the compensation committee’s decision on the change in control pay triggering a negative vote on the transaction. If a negative say-on-pay vote is anticipated, what should the compensation committee do?

Other Attorney Client Privilege Risks

In a recent 9th Circuit Case, the court reviewed a recent transaction and found that the no attorney client privilege existed when the CFO made disclosures to the attorneys for the purpose of disclosing such information to the auditors as part of the option back dating investigation.³⁵

³⁵ U.S. v. Ruehle, ___F.3d ___(9th Cir. 2009).

Thus, the attorney client privilege can easily be lost if an internal investigation has a purpose beyond preparing for litigation.

The attorney client privilege was waived by Bank of America with respect to the advice it received from counsel related to the acquisition of Merrill Lynch by a vote of the Board of Directors. The Board of Directors were under investigation by the New York state Attorney General, Andrew Cuomo and it was also negotiating a waiver of certain documents related to the suit brought by the Securities Exchange Commission related to the transaction and the bonuses awarded to Merrill employees at the end of 2008.³⁶ Thus advice which a company may have thought to be privileged could be come available to regulators in the event the political circumstances and pressures require disclosure.

Failure to Disclose Executive and Incentive Compensation Risks in Change in Control Situations

Failure to adequately or accurately disclose the executive and incentive compensation arrangements related to a change in control transaction leave the board members responsible for such failure and subject to challenge for inaccurately providing information regarding the movement to a new benefit plan. The disclosures made by BofA with respect to the Merrill Lynch acquisition demonstrate how this can happen in a change in control situation.

Additional Federal Regulators Develop an Interest in Risk Management and Governance

In comments to the National Association of Corporate Directors Governance Conference, Internal Revenue Service Commissioner, Doug Shulman encouraged the directors in attendance to keep the oversight of tax compliance on their radar screens beyond FIN 48. He suggested that they should have a mechanism to oversee tax risk as part of their governance process, for example by:

- Setting a threshold confidence level for taking a tax position;
- Discouraging or eliminating opinion shopping by tax departments by having an independent tax firm, which has some direct dialogue with the board of directors, review major tax positions; and
- Investigating further with your tax director and external auditors issues related to FIN 48 positions and how all of the material issues have been identified and the maximum tax exposure quantified with respect to uncertain tax positions as well

³⁶ “BofA to Release Details of Merrill Advice,” The Wall Street Journal, October 13, 2009, C-1.

as how the likelihood of success on a tax position was quantified and any potential penalty exposure.³⁷

Thus, at least the current Commissioner believes that corporate boards should become more involved in addressing tax issues and risks of the company, adding yet another opinion regarding the role of the Board. If the proposed executive compensation disclosure regulations are adopted as drafted and tax risk is accepted as a risk for the board to address, this will also require a review of the current board questionnaires and board member qualifications that will need to be disclosed.

The Federal Reserve also joined the mix and issued its proposals for regulating incentive compensation on October 22, 2009.³⁸

State Attorney General Activism

Five members of Bank of America's Board of Directors who sat on the audit committee were issued subpoenas by the New York state Attorney General, Andrew Cuomo, in his investigation of civil fraud charges against the CEO related to the purchase of Merrill Lynch by Bank of America. It is anticipated that all fifteen of the board members will be subpoenaed in the investigation which is reviewing whether the Bank of America board of directors "protected the rights of shareholders, were they misled, or were they little more than rubber stamps for management's decision making?"³⁹

Global Scrutiny of Executive Compensation

The G20 Summit received a report from the Financial Stability Board on Improving Financial Regulation on September 25, 2009. One segment of the report was entitled, "Improving Compensation Practices." This called for wide spread public and private sector action to ensure the governance of compensation is effective, that financial firms choose compensation practices with prudent risk taking, and that there is effective supervisory oversight and engagement by stakeholders. It called for broad based oversight of compensation structure and risk alignment including deferred, vesting and clawback arrangements. Enhanced public disclosure and transparency of compensation and enhanced supervisory oversight. Four areas were covered, governance, compensation and capital, pay structure and risk alignment and disclosure. It called for compensation committees to interact with risk committees in evaluating incentives, and in the annual compensation review by submission to either national supervisory authorities and/or public disclosure.

³⁷ Internal Revenue Service, IR-2009-095, October 19, 2009, "Prepared Remarks of IRS Commissioner Doug Shulman before the NACD Governance Conference."

³⁸ <http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm>.

³⁹ "Cuomo Calls in 5 Bof A Directors," The Wall Street Journal, Thursday, September 17, 2009, C-3.

Private Action or Public Regulation

Recently in an effort to head off federal regulation of executive compensation, a number of companies announced their intent to follow principles in compensation and tying pay to performance and reducing short term incentives. Some of these agreed to changes voluntarily give shareholders a non-binding vote on executive compensation. Some shifted from short term incentive compensation to issuing restricted stock and other pay for the executive compensation vest overtime.⁴⁰ Polo Ralph Lauren, Sysco, Eli Lilly & Co. and Ingersoll-Rand PLC all recently altered their executive pay programs voluntarily to require longer vesting and/or performance periods, increased stock-based compensation and reduction in severance and supplemental pensions.⁴¹ However, in the same article a national compensation consultant indicated he did not see any trend that indicated the bank-pay regulation has had little impact elsewhere in corporate America.⁴²

Another corporation addressed the shareholder access to proxy proposal by announcing that it intends to adopt an amendment to its Bylaws to permit reimbursement of “reasonable” expenses for a successful dissident board candidate if such candidate obtains at least 40% of the votes cast. This change takes advantage of a recent change in Delaware law allowing such a provision.⁴³

Public Relations Risk

The public relations risk may be risk to the corporate leaders’ reputation in the industry. Public relations risk incorporates the risk related to union and non-management employee risk and decisions related to the company’s decision to compensate the executives in the manner proposed. This also includes risk of union backlash in the form of strikes or similar activities which inhibit productivity in the unionized work groups.

Failure to Address Corporate Compliance Risks among Senior Management

In a recent decision by the Massachusetts Supreme Judicial Court, Astra USA recouped the compensation it had paid its form CEO under the New York “Faithless Servant Doctrine.” The former CEO had engaged in sexual harassment of female employees from 1990 through 1996. The company recouped his salary and bonuses for such period. The New York “Faithless Servant Doctrine” requires executives to forfeit misappropriated funds and pay when the officer breached his fiduciary duty to the corporation. The executive forfeited his pay and bonuses of \$6.8 million. The executive had been terminated in 1996 after allegations of widespread and pervasive sexual harassment of female employees by senior management. The company signed

⁴⁰ “Firms Back Plan to Change Pay Policies,” The Wall Street Journal, September 21, 2009, A-3.

⁴¹ “Range of Firms Alter Executive-Pay Policies,” The Wall Street Journal, Saturday-Sunday, October 24-25, 2009, A-4.

⁴² *Id.*

⁴³ “Fair Fight? Assistance is Offered in Proxies,” The Wall Street Journal, Monday, October 26, 2009, B-1.

a consent decree with the EEOC in 1998 and agreed to pay \$9.85 million to the estimated 80 employees impacted. A company needs to police all of its workers with respect to compliance with corporate policies to avoid the adverse publicity of such cases and the legal expenses related to attempts to recoup pay in such circumstances.⁴⁴

⁴⁴ *Astra USA v. Bildman*, SJC-10361, (Mass. October 5, 2009; BNA Daily Labor Report, October 15, 2009, A-9).