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Financial Reform Bill Includes Executive Compensation Provisions Applicable to All Public Companies

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The discussion draft of a financial reform bill that Senator Dodd released today[2] includes several executive compensation provisions, many of which are based on draft bills previously circulated by the Treasury Department and by other members of Congress.

Say-on-Pay. The proposed bill would mandate separate annual non-binding shareholder votes to approve (1) the compensation of named executive officers, and (2) any policy, not previously submitted for a shareholder vote, relating to the award of compensation to any principal executive officer in the event of specified M&A transactions. Notably, these requirements would apply only to shareholder meetings following the first anniversary of the bill's enactment, and therefore would not affect the 2010 proxy season.

Compensation Committee Independence. The bill would require compensation committee members to satisfy independence standards to be established by the applicable stock exchange. In addition, the bill would require compensation consultants, legal counsel and other advisers to the compensation committee to be "independent," based on rules to be promulgated by the SEC. Finally, the bill would authorize compensation committees to retain independent advisors and would require compensation committees to oversee the advisers they retain.

Additional Proxy Disclosure. The bill would mandate annual proxy disclosure (1) indicating whether the compensation committee has retained a compensation consultant and whether the work of the compensation committee has raised any conflicts of interest, (2) demonstrating the relationship between executive compensation and financial performance, (3) comparing graphically the amount of executive compensation to the company's financial performance or investor return over a 5-year period (or other period determined by the SEC) and (4) indicating whether company employees (not just executive officers) may engage in hedging transactions with respect to company stock.

Clawbacks. The bill would require, in the event of accounting restatements due to material noncompliance with financial reporting requirements, recovery of amounts in excess of what would have been paid under the restated financial statements from any current or former executive who received incentive compensation (including stock options) during the 3-year period preceding the date that restatement is required. In contrast, the clawback provision of the Sarbanes-Oxley Act covers only the chief executive officer and chief financial officer, applies only if the noncompliance results from misconduct, and relates to compensation events during the year following the misstatement.

Financial Institutions. In addition to the foregoing requirements that would apply to all public companies, the draft bill includes several compensation-related measures that specifically target banks. The bank-related provisions would (1) prohibit compensation that provides excessive pay, fees or benefits or that could lead to material financial loss, (2) permit regulators to impose higher capital standards for an insured depository institution with compensation practices that pose a risk of harm to the institution, and (3) require regulators to prohibit the payment by a depository institution holding company of executive compensation that is excessive or could lead to a material financial loss.

Many of the proposed requirements have appeared in previous legislative initiatives. However, prior draft legislation did not include the bank-related provisions described above, which overlap in part with recent guidance announced by the Federal Reserve. The draft bill raises significant interpretive questions, and likely will generate debate and alternative proposals. Public companies and their directors should monitor closely the progress of the proposed legislation.

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2 This memo was originally released on November 10, 2009.