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Administration Releases Executive Compensation Principles

Earlier today, the Department of Treasury and the Securities and Exchange Commission issued statements and fact sheets outlining the Administration's principles and proposals on executive compensation.

The Treasury Announcement

Expressing the view that executive compensation practices were a contributing factor to the current economic crisis, the Treasury announced the following set of broad-based principles that they expect to align compensation practices more tightly with the interests of shareholders and to reinforce the stability of firms and the financial system:

- Compensation plans should properly measure and reward performance;
- Compensation should be structured to account for the time horizon of risks;
- Compensation practices should be aligned with sound risk management;
- Golden parachutes and supplemental pensions should be re-examined to see whether they align the interests of shareholders and executives; and
- Transparency and accountability should be promoted in the pay setting process.

To achieve the goals articulated in the final principle above, the Treasury Department announced the Administration's support for Congressional efforts to pass "say on pay" legislation and legislation that would require listed companies' compensation committees to meet independence standards similar to those imposed on audit committees under Sarbanes-Oxley. Under the Administration's proposals, not only would compensation committee members be required to be independent, but the committee's compensation consultants and legal counsel would also be required to be independent. In addition, the "say on pay" legislation supported by the Administration would require not only a general non-binding annual vote on executive pay, but also a non-binding vote on change of control compensation disclosed in proxy solicitation materials prepared for shareholder meetings relating to mergers and other transactions that may involve a change in control of the corporation.

The SEC Announcement

The SEC announced that it is actively considering a package of new compensation disclosure rules. Specifically, the SEC's proposals will include disclosure about:

- How a company and its board manage risks;
- A company's overall compensation approach;
- Conflicts of interest of compensation consultants, including disclosure of relationships between the consultants and the company and their affiliates; and

- Director nominees, including their experience and qualifications to serve on the board or on a particular board committee and about why a board has chosen its particular leadership structure.

While the broad principles articulated by the Administration are for the most part non-controversial, it is far from clear how the substantive proposals – "say on pay" legislation and even more detailed disclosure and "independence" requirements – will advance the Administration's stated purpose of reinforcing the stability of firms and the financial system. As we have previously stated, key contributors to the current crises were the coincidence of increased stockholder pressure for ever-higher returns and weakened prudential regulation (A Crisis Is a Terrible Thing to Waste: The Proposed "Shareholder Bill of Rights Act of 2009" Is a Serious Mistake). It is difficult to imagine how a federally mandated "say on pay" rule that would stifle the corporate governance dialogue between companies and stockholders by prescribing a standard that may not appropriately address the concerns of particular shareholders or the circumstances of particular companies would improve reasonable goal-setting, firm performance or systemic stability. Similarly, federal rules mandating the composition of compensation committees and their advisors, and emphasizing "independence" – rather than increased industry expertise – and ever-expanding disclosure obligations are unlikely to improve the operation of corporate boards and long-term corporate performance.

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