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Compensation Season 2010

For many public companies, the new year marks the commencement of compensation season. Setting pay and targets for the new year, determining achievement of performance objectives for the past year and preparing the annual proxy statement contribute to a busy first quarter for compensation committees and management teams working with them. In 2010, companies will undertake these activities in a fluid environment, with executive compensation continuing to receive significant attention from shareholder activists, government and the media. As companies prepare for the upcoming compensation season, they should consider the following items.

New SEC Disclosure Requirements. Companies should take steps to ensure compliance with the new SEC rules which, among other things, address corporate governance matters, risk in compensation programs, independence of compensation consultants and the valuation of equity awards in the compensation tables (see our December 17, 2009 memorandum for a description of the new rules). Companies should get an early start on organizing appropriate working groups, crafting necessary disclosures and preparing their directors so that they can meet their obligations with respect to upcoming filings.

Assessing Risk in Compensation Programs. Companies should review their incentive compensation plans and programs with a view to whether the compensation structures encourage excessive risk taking, and should consider appropriate modifications to programs identified as excessively risky. Under the new SEC disclosure rules, to the extent that risks arising from a company's compensation programs for employees (not just executives) are *reasonably likely to have a material adverse effect* on the company, the company must discuss its compensation programs as they relate to risk management and risk-taking incentives. Importantly, the SEC release specifically notes that a company does not have to make an affirmative statement that it has determined that the risks arising from compensation programs are not reasonably likely to have a material adverse effect, if it has so concluded. Conducting a thorough analysis to determine whether company compensation programs carry the degree of risk necessitating disclosure will require lead time and a coordinated effort among company executives and directors.

SEC Hot Button Disclosure Issues. The SEC continues to express concern about the quality of disclosure regarding executive compensation, with particular focus on (1) the lack of adequate discussion in the CD&A of how and why a company arrives at specific executive compensation decisions and policies, (2) noncompliance with regard to the disclosure of performance targets and (3) inadequate detail regarding peer groups and benchmarking. Importantly, the SEC has indicated a policy shift with regard to noncompliance with its executive compensation disclosure rules. During 2007, 2008 and 2009, to the extent the SEC identified deficiencies, SEC comment letters applied to prospective SEC filings; companies did not have to amend existing filings. Going forward, the SEC has indicated that it will require companies that do not comply with the executive compensation disclosure rules to amend materially noncompliant filings.

Potential Adoption of Mandatory Say-On-Pay. The push to require public companies to submit executive compensation to an advisory "say-on-pay" shareholder vote intensified in 2009; however, it does not currently appear that broad-based mandatory "say on pay" will take effect for the 2010 proxy season. Nevertheless, directors should be aware that decisions made in 2010 may be subject to a "say-on-pay" vote during the 2011 proxy season.

Compensation Design. Compensation committees should regularly review compensation programs and consider whether existing arrangements most effectively promote a company's long-term success. In recent months, in response to the TARP regulations and the determinations of the Special Pay Master, financial institutions have instituted changes to their compensation programs, which include limiting cash compensation and paying a greater amount in the form of stock with longer vesting, performance and/or holding periods to correspond to the time horizon of risk. Some observers have suggested that these changes may eventually extend beyond the financial services industry, particularly in light of the increased focus on the relationship between compensation and risk. As always, directors should take a flexible approach to executive compensation matters, tailoring pay programs to the individual needs, strategies and risk of a particular business.

RiskMetrics. Management and compensation committees should stay abreast of RiskMetrics' positions on good and bad pay practices, as vote recommendations by RiskMetrics may influence the outcome of shareholder votes on director elections, "say-on-pay" referendums and equity compensation plan proposals. Beginning in 2010, if a company has a "say-on-pay" vote, RiskMetrics generally will use that vote as the primary avenue to address problematic pay practices. However, even for companies that include a "say-on-pay" proposal on their ballots, RiskMetrics may recommend a negative vote for compensation committee members and/or other directors if RiskMetrics considers pay practices "egregious," or in instances in which directors have failed to respond to concerns raised in prior "say-on-pay" evaluations. While directors should understand the potential consequences of their decisions under applicable RiskMetrics policies, they should not lose sight of the underlying goal of executive compensation – namely, to attract and retain qualified individuals who will contribute to the long-term success of the company.

Section 162(m). Revenue Ruling 2008-13 provides that a *right* to payment of performance-based compensation upon termination without cause, resignation for good reason or retirement *without regard to whether the performance condition is satisfied* generally will cause the entire arrangement to fail to qualify for the performance-based compensation exception to § 162(m) of the Internal Revenue Code. Companies should be mindful of the Revenue Ruling when establishing new compensation arrangements or commencing new performance periods, and should review the terms of existing compensation arrangements to ensure that they do not run afoul of Revenue Ruling 2008-13.

Section 409A. Section 409A of the Internal Revenue Code imposes penalties on participants in deferred compensation arrangements that do not comply with the strict requirements of the rules. Last week, the IRS issued Notice 2010-06, which establishes a general framework for correcting certain documentary compliance failures under § 409A, limiting or eliminating altogether any negative tax consequences. Importantly, the relief provides advantages if companies make permitted corrections on or before December 31, 2010. Companies that identify documentary compliance deficiencies should take advantage of the opportunity to take corrective action.

Compensation Clawbacks. Clawback policies provide companies with the ability to recoup incentive-based compensation in certain circumstances, such as a financial restatement, commission of an act detrimental to the company or a reversal in company performance. Over the past several years, the number of companies that have adopted compensation clawback policies has increased dramatically. Clawback policies may enhance shareholder confidence in executive accountability and may help to align company risks and rewards. A company that chooses to institute a clawback policy will need to consider a number of key design issues, as no single approach is appropriate for every company. The SEC disclosure rules require a company to disclose in its CD&A any clawback policies applicable to named executive officers.

Additional Challenges. 2009 witnessed a series of legislative proposals that would impact executive compensation matters, including with respect to "say-on-pay," independence of compensation committees and their advisors, and the relationship between compensation and risk. More is on the way.

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