Compensation Committee Governance in an Era of Increased Public Scrutiny

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by Susan P. Serota

Susan P. Serota
Executive Compensation & Benefits
+1.212.858.1125
susan.serota@pillsburylaw.com

Ms. Serota leads Pillsbury's Executive Compensation & Benefits practice and is a member of the firm's ERISA Litigation team. She has experience in all areas of pensions, employee benefits, executive compensation and stock options. She has significant experience in the compensation of senior executives, fiduciary matters relating to ERISA and other plans, international benefits, employee benefit aspects of cross-border mergers and acquisitions, joint ventures, welfare plans, ERISA fiduciary litigation and securities law matters. Most recently, Ms. Serota was recognized as "2011 Lawyer of the Year, New York Employee Benefits Lawyer" by *Best Lawyers in America* magazine.

From the headlines about excessive bonuses paid to banks' and other financial services' executives in the wake of the 2008 financial crisis to the recent Dodd-Frank Act spotlight on executive compensation at public companies, Congress, the SEC, the national exchanges, and shareholders are focused on how compensation committees make decisions on the salaries, bonuses, stock grants, and other compensation paid to executives. Thus, good governance has become even more important when making these and other decisions.

The Dodd-Frank Act has added new responsibilities and considerations for compensation committees as they determine compensation policies for their companies.

Best practices in compensation committee governance require establishing committee procedures; setting dates for consideration of compensation decisions and the review of proxy disclosures; periodic meetings with the CEO, the senior HR officer, and the lead director, if any, to determine the company's short-term and long-term goals; and examining the costs of compensation programs, employment, and severance agreements, including the real costs of parachute payments and gross-ups. Best practices also require exercising due diligence prior to making decisions, obtaining advice from outside consultants and legal advisers, and holding regular executive sessions to assure decisions are untainted by management's participation.

Committee Composition

Prior to the Dodd-Frank Act (the "Act"), the composition of a compensation committee was governed by the company's by-laws and committee charter, national securities exchange rules, and the need for at least two outside directors/non-employee directors to meet the tax and securities law exceptions relating to performance pay and equity awards. Often, the CEO was a member of the committee, even if he or she could not vote on all matters. Pursuant to the Act, the SEC will direct the national securities exchanges and associations to adopt new listing standards requiring that each member of a listed company's compensation committee, with a few exceptions, be not only a member of the board of directors but also independent. This means the company's CEO may not be a member of the compensation committee, although no prohibition bars the CEO or senior HR officer from meeting with the committee. Relevant factors to be considered when determining independence are whether a committee member received consulting, advisory, or other compensatory fees from the issuer, and whether the member is affiliated with the company, a subsidiary, or an affiliate of a subsidiary. These factors are similar to those currently required under Sarbanes-Oxley for members of audit committees.

Obtaining Advice

The Act also provides that a compensation committee may, at its sole discretion, obtain advice from a compensation consultant, legal counsel, or other adviser, but only after considering SEC defined criteria that potentially affects the adviser's independence. Criteria include the provision of other services to the issuer by the adviser's employing entity, the amount of fees received as a percentage of the entity's total revenue, the entity's policies and procedures to prevent conflicts of interest, any business or personal relationship of the adviser with a member of the committee, and any stock of the issuer owned by the adviser.

Even prior to the Act many compensation committees retained outside consultants. The Act emphasizes the use of compensation consultants who have no ties to the company or to its management. The Act now provides new statutory authority to hire a consultant (with required funding by the company), new independence standards, and the mandatory disclosure in future proxies discussing whether the committee actually retained or obtained advice from a compensation consultant, any conflict of interest that might have arisen, and how such conflict was resolved. Similar new rules apply to the compensation committee's retention of outside legal counsel and may result in more committees retaining independent counsel.

No grandfather rule for compensation consultants currently advising the committee or for current legal counsel or other advisers was provided. The retention of advisers, however, is clearly the direct responsibility of the compensation committee, which, although not required to follow the advice of its advisers, must assess the independence of current and new advisers and determine if any conflicts arise (with these advisers, their employers, or any employer's affiliate), as well as the reasonable compensation to be paid to such advisers.

Incentive Compensation and Clawbacks of Erroneous Payments

The compensation committee also must develop and implement policies on incentive compensation based on financial information previously reported under the securities laws. When a restatement is required, the company must have the right to recover or "claw back" any excess compensation (including stock options) which was based on erroneous data and paid during the 3-year period preceding the date of the accounting restatement. This requirement is mandatory and not predicated on any misconduct by the company or the executive. If the committee fails to adopt and implement such a policy, the SEC will direct the national securities exchanges and associations to delist the company.

The clawback policy should address who will be covered by the policy (required for executive officers, but could have broader coverage), what event(s) will trigger the clawback (limited to accounting restatements or also applicable to other events), what payments will be subject to the clawback and who will enforce the policy. The compensation committee will need to determine if a 3-year deferred payment, if permitted as an alternative, would be more practical and preferable to a clawback regime with questionable enforcement in certain states.

Avoidance of Material Risks

Covered financial institutions face a requirement for enhanced disclosure to federal regulators and reporting of incentive compensation arrangements that could lead to material financial loss to the institution. They are also prohibited from providing any type of incentive-based payment arrangement that may be deemed to encourage inappropriate risks. Compensation committees of these financial institutions will need to carefully consider their incentive compensation programs and confer with the institution's risk officer or committee. Such considerations, however, should not be limited to covered financial institutions. Compensation committees at other companies may also want to assure that such risks are not created by the compensation arrangements they approve.

Additional Considerations

Other provisions of the Act, although not specifically the responsibility of the compensation committee, will nonetheless impact its decisions. First, the committee should review the most recent "Say-on-Pay" vote and determine if any compensation arrangements previously approved should be changed. Although the vote is non-binding, it indicates approval or disapproval of the company's compensation policies. Further, the new, again non-binding, shareholder vote on "golden parachute" agreements for named executive officers at the time shareholder approval is requested for a merger or acquisition, spotlights these agreements. The committee should review existing and proposed agreements to determine if they are in line with best practices.

Finally, new disclosures will be required on pay versus performance. The committee should focus on setting appropriate performance targets in light of the new proxy disclosure requirements that require showing the relationship between executive compensation and the company's financial performance, taking into account any change in the value of its shares, including dividends, and any distributions.

The Bottom Line

Governance should be a top priority of any compensation committee. Process, due diligence, obtaining expert advice, and making decisions all require the committee's attention to its role and responsibilities. The Dodd-Frank Act has added new responsibilities and considerations for committees as they determine compensation policies for their companies. Obtaining and retaining the executive talent needed to lead the company are among the committee's most important responsibilities. But it is equally important for the committee to act in the best interests of shareholders. The Act's new requirements bring a new focus on the governance process for compensation committees.

Pillsbury Winthrop Shaw Pittman LLP | 1540 Broadway | New York, NY 10036 | 1.212.858.1000

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