



Regulatory Practice Letter

ADVISORY

RPL Number 09-26

Proposed Legislation to Strengthen Investor Protection through Shareholder Votes on Executive Compensation

Executive Summary

On July 16, the Department of the Treasury ("Treasury") released additional provisions to the Obama Administration's proposed legislation, the *Investor Protection Act of 2009*, which would require public companies to give shareholders an annual vote on executive compensation and also establish independence standards for compensation committees. The provisions are consistent with the Administration's recommendations for financial regulatory reform released on June 17 ("*Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation*"). Other proposed provisions to the *Investor Protection Act of 2009*, including requirements for consumer testing, disclosures and whistleblower protections, were released on July 10 (please refer to RPL 09-25).

One day following the release of the Administration's proposed executive compensation bill, Barney Frank, Chairman of the House Committee on Financial Services ("Committee")

released a discussion draft of legislation, the *Corporate and Financial Institution Compensation Fairness Act of 2009*, which incorporates the Administration's proposal in total and adds specific provisions for incentive-based pay structures employed by financial institutions. The legislation is expected to be considered by the Committee in September.

Background

The annual shareholder vote on executive compensation, commonly referred to as "say-on-pay", has been implemented in the United Kingdom since 2002. Treasury notes that studies indicate an improved link between pay and performance as a result of "say-on-pay" votes. "Say-on-pay" legislation sponsored by Barney Frank passed the U.S. House of Representatives in 2007.

Description

An outline of the proposed executive compensation provisions under the IPA follows.

Subject:

Proposed Legislation to Require Non-Binding Shareholder Votes on Executive Compensation and Establish Independence Standards for Compensation Committees;

Proposed Rule to Require Non-Binding Shareholder Votes on Compensation; and

Proposed Rule on Other Compensation-Related Disclosures

As Issued By:

**Department of the Treasury;
Securities and Exchange
Commission**

Date:

July 22, 2009

Shareholder Vote on Executive Compensation

- Any proxy or consent or authorization for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting) occurring on or after December 15, 2009, would be required to provide for a separate shareholder vote to approve the compensation of executives as disclosed pursuant to the SEC's compensation disclosure rules (which include the compensation committee report, the compensation discussion and analysis, the compensation tables, and any related materials). The shareholder vote would not be binding on the corporation or the board of directors.
- Any proxy or consent solicitation material for a meeting of the shareholders (or a special meeting in lieu of the annual meeting) occurring on or after December 15, 2009, that concerns an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of a company would be required to:
 - Disclose any agreements or understandings with the executive officers regarding compensation (present, deferred or contingent) that is based on or otherwise relates to the acquisition, merger, consolidation, sale, or other disposition of all or substantially all of the assets of that company; and
 - Provide for a separate shareholder vote to approve such agreements or understandings and compensation as disclosed.

The shareholder vote would not be binding on the corporation or the board of directors.

- The SEC would be required to establish rules and regulations to implement these requirements no later than 1 year following enactment of the proposed law.

Compensation Committee Independence:

- Each member of the compensation committee would be required to be a member of the board of directors and to be independent.
- To meet the independence requirement, a compensation committee member could not, other than in their capacity as a member of the compensation committee, the board of directors, or any other board committee:
 - Accept any consulting, advisory, or other compensatory fee or other fee from the company; or
 - Be an affiliated person of the company or any subsidiary thereof.
- The compensation committee would have the authority, in its sole discretion, to retain and obtain the advice of a compensation consultant, and would be directly responsible for the appointment, compensation, and oversight of that consultant.
- Any proxy or consent solicitation material for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting) occurring one year or more after the enactment of the *Investor Protection Act of 2009*, would be required to disclose:

- Whether the compensation committee retained and obtained the advice of a compensation consultant; or
- An explanation of the basis for the compensation committee's determination not to retain such an independent consultant.
- The compensation committee would have the authority, in its sole discretion, to retain and obtain the advice of independent legal counsel and other advisers and would be directly responsible for their appointment, compensation, and oversight.
- Any compensation consultant, legal counsel, or other adviser to the compensation committee would be required to meet standards for independence to be promulgated by the SEC.

The SEC would also be required to establish rules within 270 days of enactment, to direct national securities exchanges and national securities associations to prohibit the listing of any security of a company that is not in compliance with the standards for compensation committees. An exemption for certain categories of companies would be permitted.

Congressional Action

On July 17, Barney Frank, Chairman of the House Committee on Financial Services released a discussion draft of legislation, the *Corporate and Financial Institution Compensation Fairness Act of 2009*, which incorporates the Administration's proposed IPA legislation in total and adds specific provisions for financial institutions.

More specifically, the discussion draft would require the SEC and the federal bank, thrift and credit union regulatory agencies (the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision and National Credit Union Administration – collectively, the “Agencies”) to prescribe regulations requiring financial institutions to disclose to their primary federal regulator the structures of incentive-based compensation arrangements for officers and employees “sufficient to determine” whether the compensation structure:

- Properly measures and rewards performance;
- Accounts for the time horizon of risk;
- Is aligned with sound risk management; and
- Meets other criteria to be determined by the agencies.

The Agencies would be directed to prohibit through regulation any compensation structures or incentive-based payment arrangements that would encourage inappropriate risk taking that could 1) have serious adverse economic effects, or 2) threaten the safety and soundness of the institution.

Financial institutions covered by the draft legislation would include depository institutions, depository institution holding companies, credit unions, broker-dealers and investment advisers, as well as any other financial institutions jointly determined by the Agencies.

SEC Proposed Rules

Nonbinding Shareholder Vote on Compensation for TARP Recipients

As required by the *Emergency Economic Stabilization Act of 2008* (“EESA”), as amended by the *American Recovery and Reinvestment Act of 2009* (“ARRA”), the SEC is seeking comment by September 8, 2009 on proposed changes to its rules that would:

- Require public companies that are TARP recipients to provide a separate shareholder vote in proxy solicitations during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding. The vote would be to approve the compensation of executives, as disclosed pursuant to Regulation S-K, including the compensation discussion and analysis, the compensation tables, and any related material;
- Clarify that the separate shareholder vote would only be required on a proxy solicited for an annual meeting (or special meeting in lieu of the annual meeting) of security holders for which proxies will be solicited for the election of directors;
- Provide that registrants would be required to disclose in the proxy statement that they are providing a separate shareholder vote on executive compensation and to briefly explain the general effect of the vote, such as whether the vote is non-binding; and
- Clarify that the new rules do not require smaller reporting companies to include a compensation discussion and analysis section in their proxy statements.

Proxy Disclosure and Solicitation Enhancements

This proposal is intended to improve the disclosure provided to shareholders of public companies regarding compensation and corporate governance matters when voting decisions are made. It would be applicable to proxy and information statements, annual reports and registration statements under the *Securities Exchange Act of 1934*, and registration statements under the *Securities Act of 1933* as well as the *Investment Company Act of 1940*. The disclosures would include information about:

- The relationship of a company’s overall compensation policies to risk taking;
- The stock and option awards or executives and directors;
- The qualifications of directors, executive officers and nominees;
- The company leadership structure;
- The board’s role in the risk management process; and
- Potential conflicts of interests of compensation consultants.

Comments are due to the SEC by September 15, 2009.

KPMG Commentary

Executive compensation has been a major focus of U.S. legislators and the Administration since the *Emergency Economic Stabilization Act* (“EESA”) was passed in the fall of 2008. It began with restrictions on TARP recipients and has now moved more generally to the “say-on-pay” proposal, which is expected to benefit and protect investors through increased accountability and transparency.

For additional information, please
contact Linda Gallagher, Principal:
lgallagher@kpmg.com or Doug
Henderson, Managing Director:
douglashenderson@kpmg.com