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Practical guidance for those drafting and reviewing compensation disclosures

Fixing the Flaws in Congress's Restrictions on CEO Pay

Because of the importance of restoring public trust in the government's ability to address the economic crisis—and because this is an area where we have some expertise—we are providing the following. (As President Obama is advocating, each of us has an obligation, in our own way, to contribute solutions to the situation around us.)

Congress's and Treasury's restrictions on CEO (and senior executive officer) pay were well intentioned—and, indeed have had some positive results already—but it is clear (as GAO and others have highlighted) that serious fixes need to be made—especially if similar pay reforms will be finding their way into further legislation. The following addresses the need for (a) more clarity and (b) the need for an effective enforcement and reporting mechanism to ensure that Congress's intentions are, in fact, carried out—something that works and is not complicated or open to "interpretations" or burdensome (from the perspective of both the regulators and the companies that are subject to the restrictions).

Four Key Fixes to TARP Legislation

It is generally acknowledged that the Treasury's executive compensation provisions that arose out of the TARP legislation are lacking appropriate compliance safeguards. The following are the four key fixes that would restore public confidence in these provisions and provide a simple, appropriate mechanism (*i.e.,* proxy disclosure) to provide sunlight and ensure compliance:

1. The $500,000 Cap—The $500,000 "limit" on compensation is, in fact, only a limit on tax deductibility. In fact, some companies exceed the $1 million cap that currently applies to all public companies and simply forgo the tax deduction. There is nothing that would prevent TARP companies from doing the same.

The simple fix here is to require a captioned section in every company's proxy statement addressing the cap and quantifying any non-deductible payments over the $500,000 limit, and the resulting lost tax benefit. In this way, investors—and regulators—would know whether the company and its directors are complying with the limit. Companies should also be required to explain how the lost tax deduction factored into the compensation committee's decision-making process.

2. Bonuses and Layoffs—Bonuses to the top five Senior Executive Officers (SEOs) should not be permitted in the event the company recently had layoffs. (Some materiality standard, such as 3% or more of the workforce might be needed, as well as a reasonable time-frame, *e.g.,* the past two or three years.) Again, a simple, captioned proxy disclosure would show any bonuses granted to top executives where employees were laid off. This disclosure, too, would apply to all companies—even those under the thresholds—so that shareholders would know that the issue had been addressed by the company's compensation committee. [And, based on recent examples from financial services companies, this disclosure should probably apply to a broader group whose performance and risk-taking could have an impact on the financial health of the company. *We note that the current Tarp II proposals contain a prohibition against "bonuses and incentives" to the top 25, but fail to require this proxy disclosure sunlight/compliance insurance*.]

3. Severance and Other "Safety Nets"—It is generally acknowledged that the current 3x limit on severance under Section 280G was a mistake from the start. A few basics that should replace this TARP "limit" are:

- Termination for poor performance should not result in severance.
- Severance and change-in-control payments should not be paid where the SEO has been on the job for a reasonable period of time beyond the new hire date (*e.g.*, three years).
- Severance and other safety nets are not appropriate where the SEO has accumulated sufficient wealth (through equity gains and prior compensation etc., *e.g.*, $5 million) so that there is no "need" for a "safety net."

Severance is intended to provide a reasonable financial bridge to new employment, and executives that have sufficient financial resources from their employment do not require severance pay. Where there is a "need" and/or within the three-year new-hire period, the amount should be limited to 1x base salary and target bonus. Equity acceleration should be prohibited. (A single trigger vesting of equity and other incentives upon a CIC should count towards the TARP golden parachute limit. Currently, such amounts are excluded because they are not "paid upon termination of employment.") Again, there would be captioned proxy disclosure for all companies.

4. Risks Inherent in Equity Grants: Hold-Through-Retirement—It is generally recognized that equity compensation without a long-term holding requirement may encourage risk taking and short-term actions to drive the stock price up, rather than building lasting long-term value. Requiring TARP companies to implement a hold-through-retirement policy would address the risk concern and align executives and shareholders' interests for the long-term.

To address potential short-term risk-taking that is inherent in equity compensation grants—and to underscore the long-term incentive purpose of providing equity compensation—75% of the net after-tax portion of option stock currently outstanding held by SEOs as well as stock resulting from all future option grants would be held until the later of two years after retirement or age 65. For restricted stock grants, 50% of all grants would not vest until the later of 10 years from grant or two years after retirement. Again, this calls for captioned proxy disclosure.

It is our hope that Congress will add these important fixes to the TARP legislation to provide the necessary sunlight and compliance insurance—and to restore public trust.

—MB, DL, JMB

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