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Client Alert

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Obama Administration Outlines Broad-Based Compensation Best Practices and Lays Groundwork for Mandatory Say on Pay and New Standards for Compensation Committee Independence

The Administration's new initiatives to reform executive compensation programs and corporate governance, announced on June 10, 2009, will have broad implications for companies even beyond those receiving federal assistance. Treasury Secretary Tim Geithner outlined five general best practice compensation principles, and also outlined legislation which would give the SEC additional authority to require that all public companies hold an annual non-binding shareholder vote on executive compensation and also adhere to stricter standards of independence for Compensation Committees.

Importantly, Secretary Geithner made a point to emphasize that Treasury does not intend to cap pay, nor will it seek to prescribe in detail how companies should set pay for their executives. Rather, the Administration says it will focus on developing new standards that will reward innovation and prudent risk-taking by corporate leadership, while guarding against the use of misaligned or overly-risky performance incentives.

Treasury did not indicate any timing for the proposed legislation or its implementation. However, Senator Charles Schumer already has introduced a bill to require a Say On Pay vote at all public companies.

This Client Alert summarizes significant aspects of the Administration's proposed new mandates.

Broad-Based Compensation Principles

- Pay for Performance: Incentives for executives and other employees should be tied directly to performance that supports long-term value creation for shareholders. Performance should not be based exclusively on stock price, but on a range of internal and external measures.

- Risk Time Horizons: Requiring that executives maintain ownership of equity-based incentives for a stated period is the most effective way to link pay to performance. Compensation conditioned on longer-term performance may obviate the need for specific clawbacks. Importantly, Treasury stated that consideration of time horizon risk, as it relates to compensation plans, is appropriate not just for top executives, but for all employees involved in designing, selling and packaging both simple and complex financial instruments.

- Risk Management: Committees should have a risk assessment process that ensures pay packages do not encourage imprudent risk-taking. The results should be made public.

- Golden Parachutes and Supplemental Retirement Packages: Companies should re-examine whether these vehicles are adequately aligned with shareholders' interests and promote meaningful performance. Further, companies should consider whether top executives will be rewarded through these vehicles if shareholders are losing value.

- Transparency and Accountability: Treasury intends to seek legislation to require Say on Pay and adherence to new Compensation Committee independence standards and has issued a "Fact Sheet" for each initiative, which is intended to reinforce transparency and accountability.

Say on Pay

According to the Administration's Fact Sheet,[1] the SEC would be authorized to require all public companies to hold an annual, non-binding Say on Pay vote to approve or disapprove the following aspects of compensation:

- Executive Pay Packages as Disclosed in the Proxy Statement: This includes approval of both the narrative description of Compensation Committee decisions in the proxy's Compensation Discussion and Analysis, as well as the reported quantitative compensation data.

- Annual Compensation, Including Salary, Bonus and Other Pay Components for the Top 5 Executives: This includes a review of each amount reported in the Summary Compensation Table.

- Golden Parachutes: For shareholder meetings related to a change-in-control, this would include any golden parachute payouts.

In addition, companies have the option to also offer shareholders a non-binding vote on any other resolutions related to compensation decisions.

Compensation Committee Independence

According to the Independent Compensation Committee Fact Sheet,[2] the Administration will propose legislation directing the SEC to issue exacting new standards of independence for Compensation Committees of listed companies, including the following directives:

- Compensation Committees Must Meet Independence Standards Similar to Those in Place for the Audit Committee under Sarbanes-Oxley: Members would likely be prohibited from accepting any consulting, advisory or other compensatory fee from the company or any of its subsidiaries, or from being otherwise affiliated with the company.

- Compensation Committees Must Have the Tools to be Truly Independent: Members must have full authority over the work of any compensation consultant. Committee members must be authorized to retain compensation consultants and any other advisors deemed necessary, and such consultants must report directly to the committee. Finally, companies must provide appropriate funding, as determined by the committee, to engage compensation consultants and any other outside advisors.

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[1] See http://www.treas.gov/press/releases/reports/fact_sheet_say%20on%20pay.pdf
[2] See http://www.treas.gov/press/releases/reports/fact_sheet_indepcompcmte.pdf

- Standards Must be Issued by the SEC to Ensure Independence of Compensation Consultants: Consultants must be truly independent and free from conflict, so that they can provide committees with objective, expert advice.

Administration Appoints Special Master for Compensation and Treasury Issues TARP Guidelines

Two additional significant developments occurred on June 10, 2009. First, the Administration announced the appointment of Washington attorney Kenneth Feinberg as “Special Master for Compensation” for the Treasury Department (aka the Compensation Czar) who will have broad discretion to set pay for 175 top executives of companies that received large amounts of government assistance (the top 25 executives at each of AIG, Citigroup, Chrysler, Chrysler Credit, GM, GMAC and Bank of America). It was also announced that he will have input on the compensation structure of other institutions that received government assistance. Second, Treasury released its own long-awaited guidelines concerning restrictions on executive compensation programs at financial institutions that received government assistance under the TARP.

The TARP-related guidelines and more specifics about the Special Master’s roles will be discussed in greater detail in a forthcoming Client Alert.

Pearl Meyer & Partners
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www.pearlmeyer.com

NEW YORK
570 Lexington Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
123 N. Wacker Drive, Suite 1225
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com