



## CLIENT ALERT

### PROPOSED REGULATIONS AND LEGISLATION ON COMPENSATION

July 28, 2009

July has brought a flurry of activity in Washington, D.C. on the topic of compensation. The SEC, Treasury and Congress have all put forth proposals impacting compensation matters for a broad range of constituencies. The SEC's proposed amendment to proxy statement rules appears the nearest to fruition with a sixty-day comment period on its proposal ending September 15, 2009. The Treasury proposals are entering the legislative process, so the timing is less predictable for when they may take final form and actually take effect. This client alert summarizes the proposed regulations and legislation. As each item becomes final through either regulation or law, we will provide further communication and updates to you.

#### SEC PROPOSES CHANGES TO PROXY REPORTING

On July 10, 2009 the Securities and Exchange Commission (SEC) published a 137-page proposed amendment to the proxy statement rules. The proposed changes are open for public comment; the public comment period ends September 15, 2009. The proposal poses many questions to elicit specific comment on many of the issues in the proposal and it is expected that there will be lively debate over the specifics. While some of the specifics will undoubtedly change, the general direction taken by the SEC is expected to remain intact when the final version of the amended rules is issued. It is important to understand that the proposed rules are applicable to all publicly traded, SEC filing companies, including public financial institutions. The following is a high level summary of the key items found within the proposed rules.

- **Effective Date:** The proposed changes would apply for proxy statements filed in 2010, covering compensation through fiscal year 2009.
- **Enhanced Director and Nominee Disclosure:** The SEC is looking to require disclosure of additional detail regarding qualifications of directors and nominees. This includes past directorships, attributes or skills that qualify an individual person to serve as a director or as a member of any committee. This information would supplement existing requirements regarding directors.
- **Company Leadership Structure:** The proposed rules would require disclosure of a company's leadership structure and why the company believes it is the best structure for it at the time of the filing. This disclosure would also include rationale for why the company has or has not combined the position of the principal executive officer and the board chair.
- **Compensation Consultants:** The new rules from the SEC would require disclosure of the relationship the company has with any outside compensation consultants, including any other relationships the company has with the compensation consulting firm. For example, if the compensation consulting firm also provides 401(k) or pension administration services, it would need to disclose these additional services.
- **Report Vote Results on Form 8-K:** The proposal would move the reporting of the results of votes on shareholder proposals from the 10-K or 10-Q for the respective quarter to an 8-K disclosure. This proposal would accelerate the required disclosure to be filed within four business days after the end of the shareholder meeting at which the vote was held.
- **Equity Reporting:** The proposal would require disclosure of equity grants in the Summary Compensation Table (SCT) valued at grant-date fair value. This contrasts with the present reporting requirement under which equity is reported in the SCT on the basis of the annual GAAP accounting expense. For example, an equity grant with a grant-date fair value of \$15,000, vested over three years, would be reported as \$15,000 in the year of grant under

the proposal as opposed to \$5,000 of annual expense for three years as presently reported under GAAP. Also, the proposal would require that all prior years be restated to reflect grant-date fair value.

- **Risk Management:** One of the most critical areas addressed in the proposed regulations is the relationship between compensation and associated risk for the company. In particular, where business segments of a company have the potential to pose a material risk, the company would need to disclose the risk elements and the associated compensation policies. There are two underlying questions in this risk management proposal that are likely to garner significant comment and debate before the regulations are finalized. The first concerns the definition of a material risk. The second involves the level of disclosure of compensation policies that will be required. With respect to defining a material risk of a business segment, the SEC proposal cites several scenarios: e.g., business segments of a company that are very profitable, business segments that incur a large portion of the company's compensation expense, and business segments that have different compensation arrangements compared to the company as a whole. The proposed compensation disclosures include a discussion of the company's overall compensation philosophy, its risk assessment, claw back provisions included in incentive compensation plans, short-term versus long-term design considerations, adjustments made to mitigate identified risk elements and how the company monitors risks.

#### **TREASURY PROPOSES SAY-ON-PAY LEGISLATION**

On July 16, 2009, Treasury sent draft say-on-pay legislation to Congress as part of its initiative for comprehensive regulatory reform. This legislation would be applicable to all publicly traded, SEC filing companies, including public financial institutions. While it is early in the legislative process, this topic is expected to have traction in Congress and appears likely to be enacted. In its present form, the draft legislation contains the following requirements.

- **Effective Date:** The legislation would apply for proxy statements or consent authorizations for shareholder meetings on or after December 15, 2009.
- **Annual Shareholder Approval of Executive Compensation:** A company's proxy for annual shareholder meetings must provide for a separate shareholder vote to approve the compensation of executives disclosed pursuant to SEC compensation disclosure rules (including the compensation committee report, the compensation discussion and analysis, the compensation tables and any related materials). The result of the shareholder vote is not binding on the company or the board of directors and will not overrule a decision by the board or imply any additional fiduciary duty by the board.
- **Shareholder Approval of Golden Parachute Compensation:** A company's proxy for a shareholder meeting that concerns a proposed merger must disclose, in accordance with regulations to be promulgated by the SEC, any agreement with executive officers concerning any type of compensation that will be paid to the executives based on or related to the merger transaction, including the amount of compensation and the aggregate total. In addition, the proxy must provide for a separate shareholder vote to approve the agreements and the disclosed compensation. The result of the shareholder vote is not binding on the company or the board of directors and will not overrule a decision by the board or imply any additional fiduciary duty by the board.

## TREASURY PROPOSES COMPENSATION COMMITTEE LEGISLATION

On July 16, 2009, as part of its initiative for comprehensive regulatory reform, Treasury sent draft legislation to Congress designed to ensure that compensation committees are truly independent. Similar to the previous legislation, this proposal would be applicable to all publicly traded, SEC filing companies, including public financial institutions. This topic is also expected to have a receptive audience in Congress and appears likely to be enacted. In its present form, the draft legislation contains the following requirements.

- **Effective Date:** A company has 270 days to comply with the legislation before sanctions for failure to comply would be effective. The proposed sanctions focus on delisting the company's securities from the respective stock exchange.
- **Independence of Compensation Committee Members:** Members of the compensation committee must not receive any consulting, advisory or other compensatory fees from the company other than in their capacity as a member of the board or any committee(s) of the board. In addition, a compensation committee member must not be an affiliated person of the company or any subsidiary.
- **Independent Standards for Compensation Consultants or Other Advisors to the Compensation Committee:** Compensation consultants, legal counsel or other advisors to the compensation committee must meet standards for independence that will be promulgated by the SEC.
- **Compensation Committee Authority Relating to Compensation Consultants:** The compensation committee must have the authority to retain compensation consultants to advise the committee. The committee is directly responsible for appointing, compensating and overseeing the work of such compensation consultant. The committee is free to accept or reject the consultant's advice and is still obligated to exercise its own judgment in carrying out its duties.
- **Disclosure:** The company's proxy or consent solicitation for an annual meeting of shareholders must disclose:
  - Whether the compensation committee retained a compensation consulting firm that meets the standards for independence, or,
  - If the committee did not retain an independent compensation consultant, the basis for the committee's determination that the retention of an independent consultant was not in the interest of the shareholders.
- **Authority to Engage Independent Counsel and Other Advisors:** The compensation committee must have the authority to engage independent counsel and other advisors meeting the standards for independence to advise the committee. The committee is directly responsible for appointing, compensating and overseeing the work of such independent counsel and other advisors. The committee is free to accept or reject the independent counsel and other advisor's advice and is still obligated to exercise its own judgment in carrying out its duties.
- **Funding:** The company must provide adequate funding to the compensation committee to compensate any independent compensation consultant, independent counsel or advisor.
- **Sanctions:** The SEC shall direct national securities exchanges and national securities associations to prohibit listing of any security of a company that is not in compliance with the above requirements.
- **Study and Review:** The SEC will conduct a study and review of the use of independent compensation consultants and report to Congress on the results of the study and review within two years after the date of enactment.

## CHAIRMAN FRANK PROPOSES LEGISLATION TO “ENHANCE COMPENSATION STRUCTURE REPORTING”

On July 17, 2009, Chairman Barney Frank circulated a discussion draft of a bill to the House Finance Committee. The draft includes the legislation proposed by Treasury described above. In addition, Chairman Frank’s proposal included a section entitled “Enhanced Compensation Structure Reporting to Reduce Perverse Incentives” that, if enacted, would apply to all financial institutions (public, private, mutual, etc.). At the time of this writing, this proposal has not attracted much attention and it is difficult to assess the likelihood of enactment. The principal provisions of this proposed legislation are as follows.

- **Effective Date:** The bill calls for federal regulators to complete regulations within 270 days of enactment.
- **Required Disclosures:** Federal financial institution regulators will jointly prescribe regulations requiring financial institutions to disclose to their 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
  - Is structured to account for the time horizon of risks
  - Is aligned with sound risk management
  - Meets such other criteria as the regulatory agencies determine appropriate to reduce unreasonable incentives for officers and employees to take undue risks that could have serious adverse effects
- **Prohibition on Certain Compensation Structures:** Federal regulators will jointly prescribe regulations that prohibit any compensation structure or incentive-based payment arrangement, or any feature of such, that is determined to encourage inappropriate risk by financial institutions or officers or employees of financial institutions that:
  - Could have serious adverse effects on economic conditions or financial stability (apparently in a macro sense)
  - Could threaten the safety and soundness of the financial institution
- **Covered Financial Institutions:** The regulations prescribed under the legislation would apply to:
  - A depository institution or depository institution holding company as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)
  - A broker dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o)
  - A credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act
  - An investment advisor, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11))
  - Any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for purposes of this legislation

As mentioned above, all of the topics mentioned are in various stages of development. We are continually monitoring these important matters and will keep you abreast of new developments as they arise.

## ABOUT AMALFI CONSULTING, LLC

Amalfi Consulting, LLC is an independent consultancy which has been providing compensation consulting solutions for more than a decade. Our focus is banks and other financial institutions.

Amalfi has served over 400 banks on a national basis from de novo to large publicly-traded organizations. In addition to a full array of compensation services, we also offer board governance consulting. Our principal consultants are hands-on, personally and actively involved in every step of the consulting process.

## CONTACTING AMALFI CONSULTING, LLC

This publication is provided by Amalfi Consulting, LLC as a service to clients and to the banking community. The information contained in this publication is not to be considered as a formal opinion on legal, accounting, or actuarial issues. Questions regarding the information discussed in this publication may be directed to any of our consultants listed below. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Sean Bateman (1-866-280-3720; [sean.bateman@amalficonsulting.com](mailto:sean.bateman@amalficonsulting.com)) in our Minneapolis office.

## CONTACTS

---

Todd Leone	1-952-893-6711	<a href="mailto:todd.leone@amalficonsulting.com">todd.leone@amalficonsulting.com</a>
Gayle Appelbaum	1-952-893-6795	<a href="mailto:gayle.appelbaum@amalficonsulting.com">gayle.appelbaum@amalficonsulting.com</a>
Jim Bean	1-952-883-1370	<a href="mailto:jim.bean@amalficonsulting.com">jim.bean@amalficonsulting.com</a>
Jean Riley	1-781-934-8400	<a href="mailto:jean.riley@amalficonsulting.com">jean.riley@amalficonsulting.com</a>
Chris Richter	1-952-883-1371	<a href="mailto:chris.richter@amalficonsulting.com">chris.richter@amalficonsulting.com</a>
Katrina Gerenz	1-952-883-1384	<a href="mailto:katrina.gerenz@amalficonsulting.com">katrina.gerenz@amalficonsulting.com</a>