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New Compensation Rules for Financial Companies Might Set Trends for the Future

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Legislation enacted in response to the financial crisis contains a number of important restrictions on executive compensation in firms that participate in government programs. Extensive media attention and public outcry over executive compensation in the financial industry has led to even more proposals. While the current wave of new rules and restrictions has financial institutions scrambling to keep up and comply, the increased focus on executive compensation could have important implications that go well beyond the financial services industry. Businesses of all types and sizes are following the new rules with interest, as they may set the tone for future trends in compensation rules or "best practices" across a wide range of settings.

The first major piece of legislation enacted in response to the financial crisis was the Emergency Economic Stabilization Act of 2008, popularly called the "bailout bill" at the time of its passage in October 2008. This is the legislation that gave rise to the Troubled Asset Relief Program and related programs under which the federal government makes investments in financial institutions and other companies. In February 2009, Congress passed the American Recovery and Reinvestment Act of 2009, commonly referred to as the "stimulus bill." Both the bailout and stimulus bills contain a number of restrictions on executive compensation at companies that accept TARP funds, some of which supplement previously existing rules. In addition, ongoing publicity about compensation in the financial services industry has led to increased pressure to further restrict executive compensation and has encouraged lawmakers to propose even more regulations.

The Enron/Worldcom scandals earlier this decade and the related economic downturn spawned the Sarbanes-Oxley Act of 2002, which led to a wide array of new rules and standards for corporate governance and financial reporting. Many of these rules were technically applicable only to public companies, but they have established standards that are now widely viewed as best practices for a larger variety of entities, including nonprofit corporations. Similarly, the concepts underlying the executive compensation limitations contained in recent bailout and stimulus legislation may influence the standards for business entities well beyond the financial services industry.

One of the most fundamental executive compensation provisions in the bailout bill is a requirement that the compensation committee of any company receiving TARP funds meet with the senior risk officers of the company to review incentive compensation arrangements for senior executives. The purpose is to ensure that the senior executives are not encouraged to take unnecessary and excessive risks. The relationship between risk management and incentive compensation must be reviewed semi-annually. TARP recipients are required to make annual certifications about this review and its conclusions.

A similar risk assessment could well become part of "best practices" guidelines or more formal regulations that would apply to a larger group of business entities. The Securities and Exchange Commission has already suggested that public companies under its jurisdiction should do a regular risk/compensation assessment similar to that required under the bailout rules. There is a growing expectation that the SEC will issue broader-based compensation practice reforms, and many believe that a risk assessment requirement will be a component of any new rules or guidelines.

A key provision added by the stimulus bill is a requirement that every company receiving TARP funds hold a non-binding shareholder vote to approve the compensation of executives as disclosed in the company's proxy statement. This provision was effective immediately, and financial institutions have been including such "say on pay" proposals in proxy statements for annual meetings this spring.

The say on pay provision in the stimulus bill is the first official requirement that companies include such resolutions in their annual meeting agendas, but the concept has been gaining momentum for some time. While still in the U.S. Senate, President Obama introduced legislation requiring public companies to put such proposals before their shareholders. Many companies have received proposals from shareholders calling for a vote on executive compensation, and some of those proposals have been approved. In other cases, companies in a variety of industries have voluntarily put say on pay resolutions before their shareholders, either in response to shareholder pressure or because of a perceived trend toward these proposals as best practices. A national organization that advises institutional shareholders about voting on proposals affecting public companies has issued a position statement generally supporting say on pay, and the practice has been widely in place in Europe and elsewhere for some time.

Other examples of compensation restrictions imposed by the bailout and stimulus bills have similar potential for wider application. These include:

- "Clawback" provisions that require executives to return bonus payments if the payments were based on financial statements or results that are later restated or prove to be inaccurate;

- A requirement to adopt a corporate policy on luxury expenditures, including entertainment and events, office and facility renovations, aviation or other transportation services;

- A prohibition on compensation arrangements that "encourage earnings manipulation"; and

- Limits on types or amounts of bonus or incentive payments, and limits on the proportion of compensation that may be represented by such payments.

In some cases, the new banking legislation has tightened rules that were already in place or applied existing rules to a larger group of compensation recipients. For example, the existing limit on deducting compensation expense in excess of $1 million was lowered to $500,000 for recipients of TARP funds, and the types of compensation excluded from the limit were significantly reduced. In addition, restrictions on "golden parachutes" and other termination payments were expanded to cover more individuals and forms of payment.

Clearly, some of the most stringent limits on executive compensation imposed by the bailout and stimulus bills are not likely to be applied to all businesses. It is likely, however, that the increased scrutiny on executive compensation practices at financial companies will cause increased focus on compensation practices at businesses generally. A trend is in place to enact additional laws and regulations that govern compensation of senior executives, and further rulemaking is expected. Evidence of this trend can already be found in rules governing all public companies and in the nonprofit arena. The sources of future restrictions will include not only government, but also self-regulatory organizations, advocacy groups, trade associations and contractual arrangements. Business people in all types of settings should watch the rules that are being imposed upon financial institutions today and anticipate that similar changes might be coming for them in the future.