



# Insurance, Banks & Financial Services Bulletin



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## Executive Compensation Issues for Financial Institutions: Compensation Committee Independence and “Say on Pay”

Ongoing legislative and agency initiatives arising from the administration’s “Regulatory Reform Agenda” are increasingly moving toward “federalizing” corporate law and regulating the activities of management and boards in private business, even outside of the TARP recipient environment. As part of the Agenda, the administration is actively advocating further executive compensation oversight programs and structures for institutions that will likely entail substantial additional shareholder disclosures, further direct shareholder input on board and management activities, and opportunities for second-guessing boards irrespective of the condition of the institution and irrespective of whether it has sought or received federal assistance.

While certain of the proposals are directly applicable only to publicly-traded institutions, as often happens, all may well find their way to becoming “best practices” standards (and/or actual regulatory requirements) as their impact is felt in regulatory agencies and in the courts. Banking regulators will be asked to define and restrict compensation programs and practices which may, from their perspective, entail inappropriate or excessive risk. It remains to be seen whether the initiatives will serve their stated purpose of encouraging an appropriate corporate board focus on corporate value or result in further distraction and unnecessary pressure on already-pressured boards resulting in further difficulty in attracting and retaining qualified directors. As always, the

“devil is in the details” and close attention will need to be paid as the proposals make their way through Congress and the agencies.

### Compensation Committee “Independence” Proposals

One of the initiatives impacts board compensation committees through expanded “independence” rules. The initiative would require that board compensation committees:

1. Be composed of fully “independent” members using standards similar to the Sarbanes-Oxley audit committee requirements, and
2. Have access to and utilize experienced advisors and consultants (including legal counsel) to assist them in their deliberations that are fully “independent” of management.

Community banks, in particular, are already struggling with the regulatory cost burden and may find these further requirements a challenge to meet. Retaining special consultants and advisors in addition to those otherwise already serving the institution and its management in other capacities will impose additional costs and may well serve to further “balkanize” director/management relations. Further, the practical business impact of directors being required to retain their own “independent” consultants and lawyers in each instance would likely serve to grind business to a halt. As usual, the “one size fits all” model presents very real challenges in actual implementation.

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## “Say on Pay” Proposals

Another initiative is the “say on pay” proposal, which would require that publicly-traded institutions include a “non-binding annual shareholder vote on executive compensation” in proxy materials as well as a separate shareholder vote on “golden parachutes” in the event of a merger or acquisition.

Under the proposed rules, the “say on pay” requirements would apply to all publicly-traded institutions for annual shareholder meetings after December 15, 2009. The proposal would significantly change compensation disclosures for proxy statements and would be similar to a “no confidence” vote, which the administration states will lead to “increased dialogue between firms and shareholders on compensation.” The actual operational impact on institutions with activist shareholders would appear to be obvious.

The “golden parachute” proposal could render meaningless the contractual obligations of an institution, which can be critical in attracting and retaining key executive management, particularly for institutions, which are in the most need due to challenges facing the institutions. Query whether highly-sought experienced executives will join institutions offering the protection of a “golden parachute” if shareholders may set that protection aside when the triggering event arises.

## Conclusions

As noted, the “devil is in the details” and the timing of imposing additional burdens and uncertainty on an already-burdened industry is a challenge, given the current state of the economy and the need for businesses to be able to focus on long-term stability and growth. It remains to be seen whether the imposition of substantial additional regulatory burdens on an already-stressed industry and economy will provide benefits that exceed the burdens, particularly in light of the need to attract and retain strong experienced board members and executives. Some shareholders, particularly speculative holders and funds focused on short-term gains, may well not have the long-term best interests of the institution and its other constituencies in mind as they promote certain agendas and structures. Continually increasing the operating burden on institutions, providing further obstacles for attracting and retaining good directors and executive management, and creating a further “balkanization” of management and boards would seem inconsistent with a needed focus on creating long-term shareholder growth and value for individual institutions and for the industry as a whole.

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