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Executive Compensation and Corporate Governance Provisions in Dodd-Frank Bill

Say on Pay Votes Required at 2011 Annual Meetings; Effective Date of Other Requirements Depends on Timing of Issuance of SEC Rules

Executive Summary

The text of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) as approved by the House-Senate Conference Committee on June 25 has now been released. The Act reconciles competing versions of financial reform contained in bills passed by the House in December and the Senate in May. The next step is consideration of the Act by the House and Senate which is expected to occur in the very near future, and the President has stated he will sign any final legislation. This chronology makes it important to begin considering the Act's many provisions affecting executive compensation for public companies:[1]

- Shareholders must be provided with a non-binding vote on executive compensation (i.e., "say on pay") at least every three years; investment managers are required to report annually how they voted on each say on pay vote.
- Companies must provide shareholders with a separate non-binding say on pay vote on compensation arrangements for named executive officers related to a change in control transaction, unless they have been subject to a prior say on pay vote.
- Compensation committee members must be independent.
- The compensation committee is to be directly responsible for the appointment, compensation and oversight of any compensation consultant, independent legal counsel or other adviser that the committee retains.
- In selecting a compensation consultant, legal counsel or other adviser, the compensation committee must take into account factors affecting independence that are to be identified under rules to be issued by the Securities and Exchange Commission (SEC). Note that there is no requirement that the advisers actually be independent.
- The company must provide funding that the compensation committee determines is appropriate for payment of reasonable compensation to the committee's advisers.

[1] In addition, the Act gives the SEC authority to grant shareholders proxy access to nominate directors. This alert letter does not discuss the proxy access provisions because they are not directly relevant to executive compensation.

- The proxy statement must disclose whether the compensation committee has retained or obtained the advice of a compensation consultant, whether the compensation consultant's work has raised any conflict of interest and, if so, the nature of the conflict and how it is being addressed.
- Proxy statement executive compensation disclosure must include information showing the relationship between executive compensation and the company's financial performance.
- Proxy statements (and certain other SEC filings) must include (i) the median annual total compensation of all of the company's employees other than the chief executive officer (CEO), (ii) the annual total compensation of the CEO, and (iii) the ratio of the amount in clause (i) to the amount in clause (ii).
- Companies must develop, implement and disclose a "clawback" policy for recovery of incentive compensation. The policy applies to executive officers (current or former) in the event of certain required accounting restatements due to material non-compliance with the financial reporting requirements of the securities laws.
- The proxy statement must disclose whether any employee or director is permitted to purchase financial instruments that would hedge the value of company equity securities.
- Broker discretionary voting will not be permitted on election of directors, executive compensation (e.g., say on pay), or other significant matters.
- The proxy statement must disclose the reasons why the company has chosen to have the same person or different persons serve as board chair and CEO.
- Financial institutions will be required to disclose to their appropriate Federal regulator information regarding the structure of incentive-based compensation arrangements. The regulators are required to issue rules prohibiting any types of incentive-based compensation arrangements that encourage inappropriate risks (i) by providing excessive compensation to an executive officer, employee, director, or principal shareholder or (ii) that could lead to material financial loss to the financial institution.

Say on Pay

Approval of Named Executive Officer Compensation. Shareholders must be provided with a separate non-binding vote on approval of the compensation of named executive officers as disclosed in the proxy statement ("say on pay") at least every three years. Shareholders must also be provided with a separate non-binding vote, at least every six years, on whether the say on pay vote should occur annually, every two years, or every three years. Thus, the result may be shareholder preference for an annual say on pay vote at many companies, but it is not binding on the company which makes the ultimate decision.

Companies must provide shareholders with both votes at the first annual meeting that occurs following the end of the six-month period after the Act is signed by the President. If the Act is signed by the President in early July as expected, then these votes will be required at the 2011 annual meetings of virtually all public companies.

Approval of Golden Parachutes. In any proxy or consent solicitation relating to a meeting at which shareholders are asked to approve an acquisition, merger, consolidation or sale of all or substantially all of a company's assets (i.e., a "change in control transaction"), the person making the solicitation must disclose all agreements or understandings that the person has with named executive officers of the company (or with named executive officers of the acquiring company if the company is not the acquiring company) for any compensation relating to the change in control transaction (i.e., "golden parachute compensation"), as well as the total golden parachute compensation and the conditions under which it may be paid. Shareholders must be provided with a separate non-binding vote on approval of the golden parachute compensation, unless the agreement or understanding has previously been subject to a say on pay vote on named executive officer compensation (i.e., the golden parachute compensation was included in proxy statement disclosure of named executive officer compensation that was approved by shareholders).

The disclosure and approval requirements apply to any meeting asking for approval of a change in control transaction that occurs following the end of the six-month period after the Act is signed by the President.

Disclosure of Investment Manager Voting. Institutional investment managers are required to annually report on how they voted on each say on pay vote.

Exemption. The SEC may exempt an issuer or class of issuers from the say on pay requirements. The SEC is to take into account whether the requirements disproportionately burden small issuers.

Compensation Committee Independence

Independent Directors on Compensation Committee. The SEC is to issue rules requiring the national securities exchanges to prohibit the listing of the equity securities of any company[2] that does not have a compensation committee consisting solely of independent directors. Among the relevant factors in determining independence to be included in the SEC rules (which are likely to require changes to the current NYSE and NASDAQ independence definitions) are:

- The source of a director's compensation, including consulting, advisory and other fees paid to the director by the company; and
- Whether the director is affiliated with the company, or a subsidiary of affiliate of the company.

The SEC rules are to permit national securities exchanges to provide exemptions for particular relationships, taking into account the company's size among other factors.

Compensation Committee Authority Relating to Advisers. The compensation committee may in its sole discretion retain the advice of a compensation consultant, independent legal counsel or

[2] Certain exceptions are applicable, including those for a controlled company (defined as a company in which more than 50% of the voting securities for the election of directors are held by an individual, a group or another issuer) and foreign private issuers.

other adviser. The committee is to be directly responsible for the appointment, compensation, and oversight of the work of the advisers that the committee retains (or obtains advice from). The company is required to provide for the funding that the compensation committee determines is appropriate for payment of reasonable compensation for the services of the committee's advisers.

Independence of Compensation Committee Advisers. The Act provides that the compensation committee may only select a compensation consultant, legal counsel or any other adviser after taking into consideration factors affecting the adviser's independence as identified by SEC rules. (It does not prohibit the committee from choosing advisers who are not independent.) The independence factors, which are "… to be competitively neutral among categories of compensation consultants, legal counsel or other advisers and preserve the ability of compensation committees to retain the services of members of any such category…," are to include:

- The other services that the compensation consultant's, legal counsel's or other adviser's employer ("Adviser's Employer") provides to the company;
- The amount of the fees received by the Adviser's Employer from the company as a percentage of its total revenue;
- The policies and procedures of the Adviser's Employer that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation consultant, legal counsel or other adviser with a compensation committee member; and
- Company stock owned by the compensation consultant, legal counsel or other adviser.

Disclosure Relating to Compensation Consultant. Each proxy statement for an annual meeting that occurs on or after one year following the date the Act is signed by the President must state whether the compensation committee has retained (or obtained the advice of) a compensation consultant, as well as whether the compensation consultant's work has raised a conflict of interest. If there is a conflict, the proxy statement must disclose the nature of the conflict and how it is being addressed).

SEC Rules. The SEC is to issue rules relating to the requirements discussed above that prohibit the listing on a national securities exchange of the equity securities of any company that does not comply with the requirements.[3] The requirements do not apply to a controlled company (see footnote 2 on the prior page). The rules are to permit national securities exchanges to exempt categories of companies from the requirements as the exchanges deems appropriate. The exemptions are required to take into account the potential impact of the requirements on smaller reporting companies. The rules are to be issued within 360 days after the date the Act is signed by the President

[3] The rules are to provide companies with a reasonable opportunity to cure any defects before listing is prohibited.

Proxy Statement Executive Compensation Disclosure

Pay for Performance. The SEC is to issue a rule requiring that named executive officer compensation disclosure show the relationship between executive compensation "actually paid" and the company's financial performance, taking into account change in stock value, dividends and other distributions. The disclosure may include a graphic representation of the required information.

Compensation Comparison. The SEC is to amend its rules relating to named executive officer compensation disclosure to require each company to include disclosure of:

- The median of the annual total compensation of all employees other than the CEO;
- The annual total compensation of the CEO; and
- The ratio of the amount in the first bullet above to the ratio of the amount in the second bullet above.

Total compensation is to be determined in accordance with the SEC rules for determining the total compensation of named executive officers for purposes of the Summary Compensation Table, as in effect on the day before the Act is signed by the President.

If interpreted literally by the SEC, this new provision may prove to be the most problematic of the new executive compensation disclosure rules. For example, an issuer with 10,000 employees would be required to calculate the annual total compensation for each employee in order to compute the median value. The calculation would presumably require quantifying the values of equity awards, bonuses, perquisites, pension plans, etc. for all employees (full or part-time), and conversion of the value of payments to foreign employees into U.S dollar values. In addition, the Act does not limit the required disclosure to proxy statements, but applies it to a wide variety of SEC filings, including registration statements and quarterly and annual financial statements.

No Deadline for SEC Rules. There is no deadline for the SEC to issue the required new and amended rules.

Clawback Policy

Disclosure. The SEC is to issue rules requiring each company to disclose its policy on incentive-based compensation that is based on financial information required to be reported under the securities laws.

Clawback. The SEC rules are also to require each company to develop and implement a policy for recovery from executive officers (current or former) of incentive-based compensation in the event the company must prepare an accounting restatement due to material non-compliance with any financial reporting requirement of the securities laws. The clawback would apply to incentive-based compensation (including stock options) received during the three-year period preceding the date on which the company is required to prepare the restatement. The amount to be recovered is to based on the difference between the amount that the executive officer was paid "based on the erroneous data" in excess of what would have been paid based on the correct data. (Note that the Act does not limit the clawback to an executive officer whose fraud or malfeasance or other misconduct is responsible for the restatement.)

SEC guidance will be needed with respect to several aspects of this provision. For example, the three-year period is not measured from the date of the restatement but from the date the company is "required to prepare the restatement." Since, at least in certain cases, the requirement to prepare a restatement exists on the date the erroneous statement is issued, the requirement could literally be read to apply only to incentive compensation granted before the erroneous financial statement was first issued, which is obviously not what was intended. Also, in cases where the delivery of incentive compensation is not directly tied to a specific performance metric, guidance is needed as to how to determine the amount of incentive compensation based on the erroneous financial statement.

SEC Rules. The SEC is to issue rules requiring the national securities exchanges to prohibit the listing of the equity securities of any company that does not comply with the above requirements. There is no deadline for the SEC to issue the clawback policy rules.

Disclosure of Employee and Director Hedging. The SEC is to issue a rule requiring proxy disclosure of whether any employee or director (or designee) is permitted to purchase financial instruments designed to hedge or offset decreases in the value of company equity securities directly or indirectly held, including compensatory equity grants. The Act does not set a time limit for this rule to be issued by the SEC.

Discretionary Broker Voting. Each national securities exchange must adopt rules that prohibit broker-dealers from voting any security for which they do not receive instructions from the beneficial owner with respect to the election of directors or executive compensation, which would include say on pay votes. The SEC is given authority to extend this prohibition to "other significant matters," as determined by the SEC.

Chair and CEO. Within 180 days after the date the Act is signed by the President, the SEC is to issue rules requiring proxy statement disclosure of why the company has decided to have the same person or different persons serve as board chair and CEO. This rule represents a modest expansion of the current proxy rule requiring disclosure of the reasons that the board chair and CEO positions are filled by the same persons when these roles are combined. The disclosure under the Act is required even if the roles are split.

Enhanced Compensation Structure Reporting by Financial Institutions. Within nine months after the Act is signed by the President, the appropriate Federal regulators are required to jointly issue regulations or guidelines to require covered financial institutions to disclose to its regulator the structure of all its incentive compensation arrangements in sufficient detail for the regulator to determine whether the compensation structure:

- Provides excessive compensation, fees, or benefits to any executive officer, employee, director or principal shareholder; or

- Could lead to a material financial loss to the institution.

In addition, within nine months after the Act is signed by the President, the appropriate Federal regulators are required to jointly issue guidance prohibiting any types of incentive-based compensation arrangements determined to encourage inappropriate risks by covered financial institutions:

- by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits; or
- that could lead to material financial loss to the institution.

The "appropriate Federal regulators" are the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC and the Federal Housing Finance Agency. A "covered financial institution" is broadly defined to include any depository institution (or holding company), broker-dealer, credit union, investment adviser, Fannie Mae and Freddie Mac. In addition, the federal agencies may include any other financial institution that the regulators conclude should be covered, which, at least in theory, might expand regulation to entities currently not subject to federal regulation, such as insurance companies. There is, however, a minimum size requirement in order to be a covered institution – the financial institution must have assets of at least $1 billion.

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This letter is intended to alert compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice. Specific questions about the Act should be discussed with appropriate legal counsel. General questions about this letter may be directed to Richard Alpern in our New York offices at 212-299-3599 or by e-mail at rlalpern@fwcook.com, or David Gordon in our Los Angeles office at 310-734-0111 or by e-mail at degordon@fwcook.com. Copies of this letter and other published materials are available on our website, www.fwcook.com.