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EXECUTIVE COMPENSATION PROVISIONS OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

Today, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The 2,300-page Act contains significant new regulation of executive compensation and related corporate governance practices of publicly traded companies. While the Act has been styled as Wall Street reform legislation, the bulk of its executive compensation provisions apply broadly to public companies, not just those in the financial services industry.

We describe the executive compensation and related corporate governance provisions of the Act below:

Say-on-Pay

- The Act requires two separate shareholder votes at a public company's first annual or other shareholder meeting held more than six months after enactment for which the SEC requires compensation disclosure:
  - The first is a non-binding shareholder vote to approve the compensation of named executive officers as reported in the proxy statement.
  - The second is a non-binding shareholder vote to determine the frequency of future say-on-pay votes (*i.e.,* should it take place every year, two years or three years). Shareholders must be provided an opportunity to revisit the frequency of the say-on-pay votes at least once every six years.
- The Act also requires a non-binding shareholder vote on "golden parachutes" at shareholder meetings held more than six months after enactment for the purpose of approving a merger, acquisition or similar transaction.
  - To comply with this new requirement, a company must disclose any compensation arrangements with named executive officers that relate to the proposed transaction and the amount of compensation that may be paid to them.
  - The company's shareholders will then have a non-binding vote on the disclosed compensation arrangements, unless the arrangements previously were subject to the general say-on-pay vote described above. As a practical matter, the shareholder vote requirement applies only to golden parachute arrangements that the Company adopted or materially modified after its last general say-on-pay vote. This may be an important consideration as companies decide whether to hold annual, biennial or triennial say-on-pay votes.
- There are a few important points to note regarding these new say-on-pay provisions:

- The required shareholder votes will not be binding on the company or its board of directors and will not create or imply any change or addition to the fiduciary duties of the company or its board.

- Under current rules, companies generally must file preliminary proxy statements with the SEC at least 10 days in advance of mailing the definitive proxy statement when the agenda includes a say-on-pay proposal. It remains to be seen whether the SEC will waive this requirement, as it did for recipients of TARP funds who were required to hold say-on-pay votes under the Emergency Economic Stabilization Act of 2008. Until the SEC decides this issue, companies should factor in the time needed to file a preliminary proxy statement and respond to possible SEC staff comments when planning for the 2011 proxy season.

- The say-on-pay requirement will increase the influence of proxy advisory firms and institutional shareholders on executive pay practices.[1] In response, we expect that many companies will engage in open dialogue with these constituencies, and will further enhance their compensation disclosures, in an effort to secure the often essential institutional support for the company's executive pay practices.[2]

- The Act imposes additional restrictions on the ability of brokers to vote shares in the absence of voting instructions from the beneficial owner of those shares. Specifically, the national securities exchanges are required to adopt rules that will prohibit broker discretionary voting with respect to the election of directors, executive compensation or other significant matters determined by the SEC. This rule could make it more difficult for some companies to obtain shareholder approval under the say-on-pay vote requirement.

Claw-Back Policies

- The Act directs the SEC to issue rules prohibiting the listing of stock on a national securities exchange of a company that does not develop and implement a "claw-back" policy. The Act does not provide a specified timeframe for the implementation of these rules.

- Under the forthcoming rules, an exchange-traded company must disclose its policy on incentive compensation payable based on financial information reported under the federal securities laws.

- In addition, an exchange-traded company must maintain and develop a claw-back policy that applies in the event that the company is required to prepare an accounting

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[1] Under the Act, institutional shareholders generally are required to report annually how they voted in any say-on-pay vote.

[2] Companies should review Question 101.11 of the Compliance and Disclosure Interpretations under Regulation FD, which provides a framework for engaging in private conversations with shareholders about executive compensation matters.

restatement due to material noncompliance with any financial reporting requirement under the securities laws.

  - The policy must cover any current or former executive officer who received incentive compensation (including stock options) during the three-year period preceding the date on which the company is required to prepare an accounting restatement.

  - The policy must provide for the recovery of amounts in excess of what the executive officer would have been paid if the financial statements had reflected the restatement at the relevant times.[3]

  - The Act does not require a showing of any "misconduct" on the part of the executive officers in order for the claw-back policy to apply.

- The requirements under the Act are far broader than the claw-back requirement in the Sarbanes-Oxley Act of 2002, which applies only to the compensation paid to the company's CEO and CFO, requires a showing of "misconduct" and provides for only a 12-month look-back period.

- Exchange-traded companies that voluntarily adopted claw-back policies in the past will need to review those policies to determine whether any changes are needed to comply with the new rules (for example, many claw-back policies that were adopted by companies voluntarily require a showing of misconduct on the part of executives). Companies might also consider whether, based on their particular compensation philosophy and the impending say-on-pay requirements, it would be appropriate to adopt a claw-back policy that is broader than the new rules require.

Compensation Committee Independence

- The Act instructs the SEC to issue rules prohibiting the listing of stock on a national securities exchange unless the compensation committee of the issuer is "independent" under revised standards to be developed by the exchanges.[4]

- The forthcoming revised rules will mandate the consideration of relevant factors in determining independence, including the source of compensation of a committee member (including consulting, advisory or other compensatory fees), and whether the committee member is affiliated with the issuer or any of its subsidiaries or affiliates.

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[3] It is not clear at this point how this requirement would apply to the recovery of stock option gains. For example would it apply only to stock options that were granted or vested based on erroneous financial results, or would it also apply to options that were granted, exercised or became vested during the three-year look-back period (and if so, how would the so-called excess payment be measured in that case)?

[4] Companies will also need to consider the separate standards for determining whether compensation committee members are "non-employee directors" for purposes of Section 16 of the Securities Exchange Act or "outside directors" under Section 162(m) of the tax code.

- Certain controlled companies, limited partnerships, companies in bankruptcy, and open-end management investment companies will be exempt from the new independence standards. Foreign private issuers will be exempt from these requirements if they provide annual disclosure to shareholders of the reasons why they do not have an independent compensation committee.

Compensation Consultants and Other Advisers

- The Act gives the compensation committees of exchange-traded companies the authority to hire compensation consultants, legal counsel and other advisers and makes the compensation committee responsible for setting the compensation and overseeing the work of these advisers.

- Unlike prior proposals, the Act does <u>not</u> require that these advisers satisfy any specified independence standards. But in selecting an adviser, the compensation committee must consider the adviser's independence.

- The SEC must provide guidance on factors that affect independence and that the compensation committee must consider in selecting advisers, including: the provision of other services to the company by the adviser's firm; the amount of fees received from the company by the adviser's firm, as a percentage of the firm's total revenue; the conflict of interest policies and procedures of the adviser's firm; any business or personal relationship of the adviser with a member of the compensation committee; and any company stock owned by the adviser.

- Companies must disclose in their proxy statements whether the compensation committee retained or obtained the advice of a compensation consultant, whether there are any conflicts of interest, and if so, the nature of the conflicts and how they are being addressed.

    - This disclosure applies only to the engagement of compensation consultants; it does not apply to the use of other advisers, such as legal counsel.

    - This new rule will need to be reconciled with existing proxy rules regarding compensation consultants, which already require disclosure of the role played by compensation consultants in recommending the amount or form of compensation to executives or directors (expanded disclosure is required if the consultant provides more than $120,000 worth of "additional services" to the company in a fiscal year).

- The rules regarding compensation committee advisers will be effective for the first annual meeting (or special meeting in lieu of an annual meeting) occurring one year or more after enactment. Controlled companies are not subject to these new requirements, and the SEC has the power to exempt other companies as well.

Additional Compensation Disclosures

- *Pay Versus Performance Disclosure*. The Act directs the SEC to amend the proxy rules to require disclosure of the relationship between compensation actually paid to named executive officers and the company's financial performance (taking into account any change in the value of the company's stock and dividends and distributions). The Act specifically provides that the disclosure may include a graphic representation, which suggests that it may be similar to the "performance graph" required in the annual report.

- *CEO Pay Equity Disclosure*. The Act also requires that the SEC amend the proxy rules to prescribe disclosure of (i) the median of the annual total compensation of all employees of the company, other than the CEO, (ii) the annual total compensation of the CEO, and (iii) the ratio of those two amounts.

    - In calculating CEO and all other employee compensation for this purpose, the company will include the same elements of compensation disclosed in the Summary Compensation Table. Calculating compensation for named executive officers in the Summary Compensation Table has proven to be difficult for many companies, particularly calculating the change in pension value and perks. Attempting to calculate these amounts for all employees will present a significant challenge to employers. Hopefully the SEC will streamline the process for calculating annual total compensation for potentially large numbers of non-NEO employees.

- *Employee/Director Hedging Disclosure*. The Act directs the SEC to amend the proxy rules to require disclosure of a company's policy on whether employees (not just executive officers) or directors are permitted to hedge or offset any decrease in value of equity compensation shares. Note that some companies already disclose this information - with respect to named executive officers - in the Compensation Discussion and Analysis section of the proxy statement pursuant to Item 402(b)(2)(xiii) of Regulation S-K.

- *Effective Date*. The Act does not specify an effective date for these additional disclosure rules, and it remains to be seen whether the SEC will implement these rules in time for the upcoming proxy season.

CEO/Chairman Disclosure

- The Act directs the SEC to amend the proxy rules within 180 days after enactment to expand the disclosure of the relationship between the CEO and Chairman of the Board roles.

- Under the forthcoming rules, a company will be required to explain why it has chosen to either (i) have the same person serve as CEO and Chairman of the Board, or (ii) separate the CEO and Chairman roles.

- This new rule will need to be reconciled with existing proxy statement disclosure rules, which require a company to discuss its leadership structure and why it believes that its

structure is the best or most appropriate (including whether and why it has combined or separated the functions of CEO and Chairman, whether and why it has a lead independent director, and the specific role played by a lead independent director in the leadership of the company).

Special Disclosure Rules and New Regulations for Covered Financial Institutions.

- The Act also contains special disclosure rules for "covered financial institutions" with at least $1 billion in assets. The Act broadly defines "covered financial institution" to include privately owned and publicly owned banks, broker dealers (registered under the Securities Exchange Act), investment advisers (registered under the Investment Advisers Act) and credit unions.

- The Act provides that federal regulators (such as the Federal Reserve, Comptroller of the Currency, FDIC, SEC and others) are to jointly publish regulations within nine months after enactment that will prohibit a covered financial institution from maintaining incentive-based compensation arrangements that (i) encourage inappropriate risk by providing excessive compensation, or (ii) could lead to material loss by the institution.

- These same regulators will also publish regulations requiring a covered financial institution to report the structure of its incentive-based compensation arrangements with sufficient detail to allow regulators to determine whether a financial institution's incentive-based plans could result in excess compensation or could result in material financial loss.

- It is not clear how these regulators will define "excessive compensation" for purposes of the Act. However, it is worth noting that the recently published Guidance on Sound Incentive Compensation Policies (developed by many of the same regulators tasked with establishing rules for financial institutions under the Act) is largely principles based and does not seek to establish rigid standards. It is possible that these regulators will take a similar approach in establishing the guidance called for by the Act.

Broker Voting

The Act requires national securities exchanges to adopt rules that will prohibit brokers from granting proxies to vote shares with respect to the election of directors, executive compensation or other significant matters determined by the SEC, unless the beneficial owner of the shares has given voting instructions to the broker. The further reduction in situations in which brokers would have the authority to vote uninstructed shares will increase the need for careful management and monitoring of the company's proxy voting process, even in uncontested or non-controversial matters.

Proxy Access

The Act provides specific authority to the SEC to issue so-called "proxy access" rules that may provide new procedures to allow certain large shareholders to include nominees to the Board of Directors in the company's proxy statement, thus ending the persistent debate concerning the

SEC's authority to promulgate such rules under its existing statutory authority. In 2009, the SEC proposed proxy access rules, and public companies should expect the SEC to revisit those proposed rules in light of the authority provided by the Act. Significantly, the Act leaves it to the SEC to make the important decision as to the ownership percentage threshold that will entitle a shareholder to proxy access for this purpose.

Conclusion

The Act has broad implications for the executive pay and corporate governance practices of all public companies. Although it will take some time for regulators to issue guidance under the Act, companies should begin to assess and consider how the Act will impact their executive pay practices and the planning process for the 2011 proxy season.

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