A Timely Analysis of Legal Developments

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173), which is primarily focused on regulating practices of the financial services industry (the "Act").

Executive Compensation and the Wall Street Reform and Consumer Protection Act

By Nick Linn, Ilyse Schuman and Ellen Sueda

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173) (the "Act"), which is intended "to promote the financial stability of the United States by improving accountability and transparency in the financial system" and "to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." While the Act is directed at the financial system, it incorporates broad executive compensation provisions that apply beyond the financial services industry. Publicly-traded companies need to understand and prepare for these new requirements. Included in Subtitle E of Title IX – Accountability and Executive Compensation ("Subtitle E") – of the Act are laws generally related to executive compensation practices of publicly-traded companies and certain financial institutions. The laws enacted under Subtitle E amend the Securities Act of 1933 and Securities Exchange Act of 1934 (the "Exchange Act"), and also direct the Securities Exchange Commission (SEC) and certain other Federal Regulators to adopt rules consistent with the new law.

The following is a summary of the rules in Subtitle E of the Act relating to executive compensation.

Shareholder Approval of Executive Compensation

Regular Approval of Executive Compensation: Commonly known as say-on-pay, this rule allows shareholders a non-binding vote on the compensation paid to named executive officers.

- Effective Date: The proxy statement (or consent or authorization) for the first annual or other shareholder meeting occurring after January 21, 2011 must include the say-on-pay proposals.
    - In other words, companies that utilize the calendar year for disclosure purposes will be required to include such say-on-pay proposals in their 2011 annual meeting proxy statements.

- Resolutions: Such proxy materials must include a separate resolution providing shareholders a vote on: (i) the non-binding opportunity to approve the compensation paid to named executive officers; and (ii) the frequency of voting on executive compensation.
- Frequency: Shareholders must decide at their first meeting occurring after January 21, 2011, how often to conduct such non-binding say-on-pay votes (*i.e.*, every year, every other year, or every third year). The shareholders' decision on the frequency of such say-on-pay votes is likewise non-binding. However, companies must allow their shareholders to vote on executive compensation at least every three years and determine how often to conduct such voting every six years.
- Considerations: To date, shareholders generally have been provided only an "up or down" vote with regard to the overall pay packages of named executive officers. It will be interesting if the regulations ultimately adopted by the SEC will allow companies to present to shareholders the ability to vote on each element of named executive officers' compensation.
- The U.K. implemented a similar law in 2002. At the time, it was thought that such say-on-pay votes would curb (or "kerb" as they say across the pond) executive pay, but there are conflicting opinions as to whether the law has had such an impact.

<u>Shareholder Approval of Golden Parachute Compensation</u>:

Shareholders are allowed a non-binding vote on compensation paid to named executive officers in connection with an acquisition, merger consolidation, or proposed sale or other disposition of all or substantially all of the assets of the company (the "Corporate Transaction") that was not previously disclosed and voted upon.

- Effective Date: This new law applies to any proxy, consent or authorization for an annual or other shareholder meeting occurring after January 21, 2011, at which the shareholders are asked to approve the Corporate Transaction.
- Disclosure: The rules will apply to any compensation arrangement or understanding (whether present, deferred, or contingent), between a named executive officer and the company or successor/acquiring company, based on the Corporate Transaction. The disclosure must set forth the aggregate total of all applicable compensation (and any related conditions) that may be paid to the named executive officer. The disclosure must have a separate resolution relating to the applicable compensation upon which shareholders will vote.

<u>Effect of Rule</u>: As indicated above, the shareholders' vote on executive officer compensation is non-binding on the company's board of directors. Irrespective of the shareholders' vote, the board retains full authority to make decisions regarding executive compensation and no additional fiduciary obligations are to be imposed upon the board as a result of the shareholders' vote. It is also important to note that this new rule in no way restricts or limits shareholders from making additional proposals related to executive compensation.

<u>Disclosure of Voting by Institutional Investment Managers</u>: Every institutional investment manager that is subject to section 13(f) of the Exchange Act must report at least annually how it voted on executive compensation, whether through the regular process or in connection with a Corporate Transaction.

<u>Exemption</u>: In its authority to establish rules consistent with this section of the Act, the SEC will allow a national securities exchange/association to exempt a category of companies from the above requirements, taking into account the impact of such requirements on smaller companies.

Compensation Committee Independence

<u>Independence of Compensation Committee Members</u>: Board members serving on the compensation committee of a publicly-traded company must meet heightened standards of independence that are to be imposed by the national securities exchanges/associations (*e.g.*, NYSE, NASDAQ) pursuant to new rules to be established by the SEC.

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- Independence: In defining "independence," the SEC must take into consideration: (i) the source of compensation provided by the company to any member of the board, including consulting, advisory or any other compensatory fee; and (ii) whether a member of the board is affiliated with the company, any subsidiary of the company, or an affiliate of any subsidiary of the company.
- Exemptions: The SEC has the latitude to adopt rules that will permit an exemption for certain companies, taking into consideration a company's size or other relevant factors.

Independence of Compensation Committee Advisers: When selecting compensation consultants, legal counsel or other advisers (collectively, "Advisers"), the compensation committee must consider factors that can affect their Advisers' independence.

- Independence: The SEC will identify factors that affect the independent nature of the Advisers, including: (i) other services that the Advisers' employer provides to the company; (ii) the amount of fees, as a percentage of total revenue, that the Advisers' employer receives from the company; (iii) conflict of interest policies and procedures that the Advisers' employer has adopted; (iv) any business or personal relationship that the Advisers have with a Committee member; and (v) company stock that the Advisers own.
- Considerations: Compensation committees of most large publicly-traded companies have independent Advisers. However, with the consolidation of large human resources consultants, it may become increasingly difficult to find a large, independent advisor. In light of the new rules, compensation committees and companies will need to reexamine the "independence" of their Advisers.

Compensation Committee Authority to Retain Advisers: Compensation committees must have absolute discretion to retain or obtain advice from the Advisers and will be directly responsible for the appointment, compensation and oversight of such Advisers. However, the Committee is not bound by the advice nor recommendations received from the Advisers and retains complete discretion to exercise its own judgment in fulfillment of its duties.

- Disclosure: Each company must disclose in its proxy or consent solicitation materials for an annual or special shareholder meeting occurring on or after July 21, 2011: (i) whether the compensation committee retained or obtained the advice of an Adviser who is a compensation consultant; and (ii) whether the compensation consultant's work has raised any conflict of interest, the nature of the conflict and how the conflict is being addressed.
- Funding: Companies must provide funding for the compensation committee to retain Advisers.

Exemption

- SEC Discretion: In its authority to establish rules consistent with this section of the Act, the SEC will allow national securities exchanges/associations to exempt a category of companies from the above requirements, taking into account the impact of such requirements on smaller companies.
- Controlled Companies: Controlled companies, which are listed on national securities exchanges/associations and in which majority voting power is held by an individual, a group or another issuer, will be exempt from these rules.

Penalties: The penalty for noncompliance with the above rules is delisting from national securities exchanges/associations.

- The SEC rules will provide a noncompliant company the opportunity to cure defects prior to a company's delisting.

Executive Compensation Disclosures

Pay versus Performance: The SEC will establish rules that will require companies to disclose as required under section 402 of Regulation S-K (the description of executive compensation generally reported in the proxy or Form 10-K) the relationship between

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compensation actually paid to named executive officers and the company's financial performance. This required disclosure may include a graphic representation of the information required to be provided.

- Financial Performance: Financial performance takes into account any change in stock value and dividends, and any distributions.

Additional Disclosure: The SEC executive compensation disclosure rules will require that companies disclose the following:

1. The median of the annual total compensation of all employees of a company (Total compensation of an employee will be determined in accordance with the determination of a named executive officer's total compensation, as is currently required to be reported in column (j) of the company's summary compensation table.), except the CEO;
2. The annual total compensation of the company's CEO; and
3. The ratio of the amount in #1 above to the amount in #2 above.

Recovery of Erroneously Awarded Compensation

Recoupment/Clawback: The SEC will establish rules that will require companies to develop, implement and disclose a policy relating to the recoupment of certain incentive-based compensation, if: (i) the incentive-based compensation is based on performance criteria of reported financials; and (ii) the company restates its financials due to material noncompliance with financial reporting requirements.

- Application: The recoupment policy must apply to both current and former executive officers of the company who received the incentive-based compensation at issue.
- Limits: Only excess compensation is to be recouped. In other words, executive officers will not be required to return the portion of incentive compensation they would have earned had the financials been originally reported correctly.
- Timing: Companies are required to recoup excess incentive-based compensation in the three-year period prior to the date the company is required to prepare the financial restatement, not three years prior to the filing date.

Penalties: The penalty for noncompliance with the above rules is delisting from national securities exchanges/associations.

Disclosure Regarding Employee and Director Hedging: The SEC will establish rules that will require companies to disclose in its proxy or consent for an annual shareholder meeting whether any employee or board member, or designee of any employee or board member, is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities.

- Limit: The equity securities at issue must have been either: (i) granted as compensation to the employee or board member by the company; or (ii) held directly or indirectly by the employee or board member.
- Note: The law is not limited to executive officers of a company, but extends to all employees of a company.

Enhanced Compensation Structure Reporting

Disclosure and Reporting of Compensation: Not later than April 21, 2011, Federal Regulators (defined below) will prescribe regulations or guidelines requiring a covered financial institution (defined below) to disclose to the appropriate Federal Regulator the structure of all incentive-based compensation arrangements, such that the Federal Regulator can determine whether such compensation arrangements: (i) provide an executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits; or (ii) could lead to a material financial loss to the institution.

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Prohibition of Certain Compensation Arrangements: Not later than April 21, 2011, Federal Regulators will prescribe regulations or guidelines that prohibit incentive-based compensation arrangements or features that the Federal Regulators determine encourage inappropriate risks by covered financial institutions: (i) by providing an executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits; or (ii) that could lead to a material financial loss to the institution.

Standards: The appropriate Federal Regulators will ensure that the standards for the above rules are comparable to standards under, and take into consideration compensation standards described in, the Federal Deposit Insurance Act.

Enforcement: The law and rules will be enforced under section 505 of the Gramm-Leach-Bliley Act.

Definitions

- "Federal Regulators" means the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the FDIC, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC and the Federal Housing Finance Agency.
- "Covered Financial Institution" means a depository institution or depository institution holding company, a registered broker dealer, a credit union, an investment advisor, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and any other financial institution that the Federal Regulators deem a covered financial institution. However, any "covered financial institution" with less than $1 billion in assets will be exempt.

Voting by Brokers: The Exchange Act rules are amended to allow only beneficial owners to grant a proxy to vote securities on matters relating to the election of members of a board, executive compensation, or any other significant matter (as the SEC determines). If a beneficial owner grants a proxy to vote, then the beneficial owner must provide voting instructions.

Checklist for Compliance with Material Provisions of the Act

Shareholder Meeting

Determine in which proxy or other solicitation document you will need to include the Say-on-Pay and Pay versus Performance resolutions.

Say-on-Pay

- Prepare resolution for shareholder vote on the approval of executive compensation.
- Prepare resolution for shareholder vote on the frequency of voting on executive compensation.
- Determine if you will have a Corporate Transaction that is subject to shareholder vote.
  - If yes, determine whether shareholders have previously approved any applicable executive compensation.
  - If there is applicable executive compensation not previously disclosed, prepare resolution for shareholder vote on the executive compensation related to the Corporate Transaction that shareholders have not previously voted upon.

Pay versus Performance

- Prepare disclosure of executive compensation in relation to your financial performance.
- Determine whether a graphic representation should be included.

Comparative Pay

- Determine the median of the annual total compensation of all employees of the company, except for the CEO.

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- Determine the annual total compensation of the CEO.
- Determine the ratio by dividing the median pay by the CEO pay.

Recoupment/Clawback

- Prepare a recoupment policy consistent with the SEC regulations.
- Disclose the recoupment policy after adoption.
- Ensure implementation of recoupment policy after adoption.

Compensation Committee Independence

- Reexamine the independence of your Compensation Committee members.
- Establish a policy for Compensation Committee engagement of advisers.
- Prepare an audit checklist for existing or potential advisers to the Compensation Committee for independence.
- Audit existing or potential advisers to the Compensation Committee for independence.
- Disclose required information regarding Compensation Committee Advisors in proxy or solicitation materials.

Employee and Director Hedging

- Establish a policy regarding employee and director hedging (this is not required but recommended.)
- Audit directors and employees regarding hedging activities.

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