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Financial Reform Act Brings Significant Executive Compensation Change

The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* was passed today by the Senate and is expected to be signed into law shortly.[1] The Reform Act represents a comprehensive banking and securities law overhaul primarily aimed at financial sector reform, but it contains a number of executive pay provisions that will apply to nearly all public companies. We summarize below the key parts of the legislation related to compensatory matters generally.[2]

Clawback Policies

National securities exchanges and associations, such as the NYSE and Nasdaq, are required to adopt rules prohibiting the listing of the securities of companies that do not implement an incentive compensation recoupment policy. When a listed issuer prepares an accounting restatement as a result of its material noncompliance with any financial reporting requirement, the issuer must recover all incentive-based compensation (including stock options) paid to current or former executives during the three years preceding the date on which the restatement is required. There is no requirement that the restatement be triggered by the misconduct of the issuer or any employee. The amount of compensation recoverable will be the excess of what was actually paid to the executive over the amount that would have been paid under the accounting restatement. Issuers must also disclose their clawback policies.

The Reform Act does not specify an implementation date for the rules on clawbacks. Further, it does not expressly exclude foreign private issuers from this provision, although later rulemaking may provide for such an exception. Most public companies will need to revisit existing clawback policies to ensure they comply with the Reform Act requirements.

1 The Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, was passed by the House of Representatives on June 30, 2010.
2 Additional rules apply to certain financial institutions regarding enhanced disclosure requirements and compensation arrangements that could encourage inappropriate risk, a discussion of which are beyond the scope of this Memorandum.

Mandatory Say-on-Pay

Domestic issuers must provide shareholders with the right to cast a non-binding vote approving the issuer's executive compensation as it is disclosed in the Compensation Discussion and Analysis section of the issuer's proxy statement and accompanying tabular and narrative disclosure. Unlike certain prior proposals calling for an annual vote, the Reform Act requires a vote to occur at least once every three years.

All shareholder meetings occurring on or after six months following the enactment of the Reform Act must provide shareholders with a say-on-pay vote. In the first instance, shareholders must be given the opportunity to vote on both (1) the say-on-pay resolution and (2) a separate resolution to determine whether the issuer's say-on-pay vote will be held every one, two or three years. Thereafter, shareholders must be given the opportunity to redetermine the frequency of the say-on-pay vote at least once every six years.

The say-on-pay vote is non-binding and will not be construed as:

- overruling the compensation decisions of the issuer's board of directors;
- imposing additional fiduciary duties on the board; or
- limiting shareholders' ability to make compensation-related proposals for inclusion in proxy statements.

The Reform Act also requires all institutional investment managers subject to Section 13(f) of the Securities Exchange Act of 1934 to report at least annually how they voted on any say-on-pay matter and any "golden parachute" advisory vote (described below).

Several public companies have voluntarily implemented say-on-pay policies to date. While a significant majority of these resolutions passed, several companies failed to win majority support of their compensation policies during the 2010 proxy season. Winning approval for say-on-pay (and other compensation-related shareholder proposals) may prove more challenging in future years as the Reform Act disallows discretionary votes by brokers on these proposals.

Disclosure and Vote on Golden Parachutes

Proxy statements and consent solicitations filed by domestic issuers in connection with mergers, acquisitions, and major asset sales are required to describe, in clear and simple form, any arrangements with any named executive officers of the issuer or the acquiring company concerning compensation (whether present, deferred or contingent) that is related to the transaction. Companies will also be required to disclose the aggregate amount of compensation that will be paid or may become payable to the NEOs (together with the conditions to payment) as a result of the transaction. The SEC is directed to promulgate regulations governing the specifics of this disclosure.

The proxy statement also must provide shareholders the opportunity to cast a separate non-binding vote to approve these payments unless the arrangements have been previously subject to a say-on-pay vote. As is the case with the say-on-pay vote, the "golden parachute" advisory vote will not overrule the board's compensation decisions or impose additional fiduciary duties on the board.

Like say-on-pay, this requirement applies only to US issuers and not to foreign private issuers. This provision applies to all meetings occurring six months after the enactment of the Reform Act.

Compensation Committee Independence

The Reform Act requires the SEC to direct the national securities exchanges and associations to prohibit the listing of securities of any issuer whose compensation committee is not comprised exclusively of independent directors. Compensation committee independence rules must be enacted by the national securities exchanges and associations 360

days from the enactment of the Reform Act. Rather than setting explicit independence standards, the Reform Act tasks listing authorities with defining independence. In formulating this definition, listing authorities are to consider:

- the source of compensation of the director, including any consulting, advisory, or other fees paid by the issuer; and
- whether a director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

The compensation committee independence requirements do not apply to certain issuers, including "controlled companies" (e.g., companies where more than 50% of the voting power is held by an individual, a group or another issuer) and foreign private issuers that provide annual disclosure explaining why they do not have an independent compensation committee.

Compensation Committee Adviser Independence

The Reform Act provides that a compensation committee (1) may, in its sole discretion, obtain advice of consultants, legal counsel and other advisers and (2) must be directly responsible for the appointment, oversight and compensation of these advisers. Any committee that elects to retain a consultant, however, will not be compelled to follow the adviser's advice and must exercises its own judgment in fulfilling its duties and making compensation decisions. Issuers are required to provide funding for the adviser compensation determined by the committee.

In selecting its advisers, compensation committees must take into account factors affecting independence. The Reform Act directs the SEC to identify independence factors that are competitively neutral among categories of consultants, legal counsel and other advisers, and provides the following partial list of considerations:

- provision of other services by the adviser's employer;
- the amount of fees paid to the adviser's employer, considered as a percentage of the employer's total revenues;
- the policies and procedures of the adviser's employer that are designed to prevent conflicts of interest;
- any business or personal relationship between the adviser and a member of the compensation committee; and
- the adviser's ownership of stock of the issuer.

Unlike prior proposed legislation, the Reform Act does not require that consultants be independent. Rather, in any proxy statement filed on or after the first anniversary of the enactment of the Reform Act, issuers must disclose (in accordance with rules to be established by the SEC): (1) whether the compensation committee retained a consultant; (2) if the consultant's work raised a conflict of interest; and (3) if so, how that conflict is being addressed.

Within one year following enactment of the Reform Act, the SEC must adopt rules requiring the listing authorities to prohibit the listing of an issuer's securities if an issuer do not comply with the consultant and adviser independence rules. The listing authorities must also establish procedures providing issuers with a reasonable opportunity to cure any defect before delisting.

The compensation consultant independence provisions also do not apply to "controlled companies."

Additional Disclosure

The Reform Act directs the SEC to require the following additional compensation-related proxy disclosure:

- The relationship between compensation actually paid to the issuer's named executive officers and the financial performance of the issuer, taking into account any change in the stock value and dividends paid. Issuers may use a graph to illustrate the relationship.

- The median total annual compensation of all employees (other than the CEO), the annual total compensation of the CEO, and the ratio of these two amounts. Total compensation would be calculated in the same manner as in the summary compensation table.
- Whether all employees (not only executive officers) or directors (or their designees) can hedge against decreases in the value of stock granted as compensation or otherwise directly or indirectly held by the employee or director.

The Reform Act does not specify a deadline for the SEC's rulemaking relating to additional disclosures.

While on their face these additional disclosures might not appear overly problematic, in practice, they are likely to draw significant attention and add fuel to the fire of the Main Street versus Wall Street compensation debate. In addition, compilation of the information required to formulate the first two disclosures – particularly the CEO pay ratio disclosure – may prove a daunting task for many companies.

Conclusions

The executive compensation provisions of the Reform Act have been long anticipated and will require many companies to reexamine their compensation policies and procedures in the near term. We expect to publish memoranda providing an in-depth discussion of several of the executive compensation provisions of the Reform Act shortly.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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