Proskauer

The Impact of Financial Reform on Executive Compensation

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On July 15, 2010, the Senate passed The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which provides for sweeping changes in the regulation of consumer and investor protection, the financial services industry, executive compensation and corporate governance, in an effort to enhance enforcement, transparency and accountability.[1] The Act passed the House of Representatives on June 30, 2010 and, at press time, is expected to be signed into law by President Obama on July 21, 2010 (the date of signature being the "Enactment Date").

Although the Act focuses in large part on regulating the financial services industry, it includes a number of significant executive compensation and corporate governance provisions that will apply broadly to public companies without regard to industry. This Alert summarizes the key executive compensation and corporate governance provisions in the Act.[2]

"Say-on-Pay" Vote — Shareholder Approval of Executive Compensation

Under the Act, public companies must provide shareholders with a "say-on-pay" vote to approve the compensation of their "named executive officers"[3] as disclosed in the Summary Compensation Table contained in companies' proxy statements at least once every three years. The Act provides that the shareholder vote on executive compensation is not binding on the company or the compensation committee and does not purport to change the legal authority or change or increase the fiduciary duties of public company directors; however, the say-on-pay rules are intended to give public company shareholders a mechanism for supporting or opposing their company's executive compensation practices and are intended to encourage public company boards (and their compensation committees) to consider and follow the shareholders' advisory vote on the company's executive compensation program. The say-on-pay rules should not be construed as restricting or limiting the ability of shareholders to submit executive compensation proposals for inclusion in proxy materials.

The Act also requires companies to submit to its shareholders, at least once every six years, a vote as to the frequency of the shareholder vote on executive compensation (*i.e.,* whether the vote will occur every one, two or three years).

Companies must comply with each of these requirements – shareholder approval of executive compensation and the frequency of such shareholder approval – in their proxy materials for the first shareholder meeting occurring more than six months after the Enactment Date. As a result, both of these votes generally will be required at the 2011 annual meetings of all U.S. public companies with annual meetings on or after January 21, 2011, assuming the President signs the Act on July 21, 2010. However, the SEC has the authority to exempt certain companies from these requirements by rule or order. Among other factors considered by the SEC in determining whether to grant such an exemption, the Act requires the SEC to consider whether the say-on-pay provisions would disproportionately burden small issuers.

Notably, the shareholder approval provisions of the Act provide that institutional investment managers must report, no less than annually, how they voted on the say-on-pay proposal.

While a say-on-pay vote is nonbinding under the Act, it is not without meaning. It is expected that the recommendations of organizations such as RiskMetrics and other shareholder groups will likely become increasingly relevant as a result of the say-on-pay votes process. Say-on-pay may impact the Compensation Discussion and Analysis ("CD&A") portion of companies' proxy statements since this is the primary means for companies to communicate with their shareholders on executive compensation decisions and the rationale behind such decisions. It is anticipated that companies will seek to avoid negative say-on-pay votes by justifying their pay practices in their CD&As and, perhaps, by choosing to rely more heavily on outside compensation consultants.

Finally, the say-on-pay provisions may present an interesting dynamic between management and the compensation committee with respect to the company's CD&A. When it adopted the CD&A regime in 2006, the SEC made clear that the CD&A was to be a report of management and not of the compensation committee, and that the compensation committee report only must address whether the compensation committee has reviewed and discussed the CD&A with management, and whether it recommends to the board that the CD&A be included in the proxy statement. To the extent that the CD&A discusses compensation practices subject to a shareholder say-on-pay vote, the compensation committee may find that its recommendation warrants heightened consideration, particularly depending on the level of disclosure of the committee's involvement and role in designing and/or approving such compensation practices.

"Say-on-Parachute" Vote — Shareholder Approval of Golden Parachute Compensation

In the proxy materials for a meeting where shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of a public company's assets, the proxy must disclose:

- any agreements or understandings with any named executive officer of the company concerning any type of compensation (including deferred and contingent compensation) that is based on or otherwise relates to the transaction;
- the conditions under which such compensation may be paid or payable; and
- the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or payable to or on behalf of such officer.

The Act provides that the requisite disclosure for these "golden parachute" arrangements must be made in a "clear and simple form" in accordance with regulations to be issued by the SEC; however, the Act does not prescribe any particular format for such disclosure.[4]

To the extent that the compensatory arrangements for which disclosure is required have not been previously subject to a vote by shareholders under the say-on-pay provisions of the Act, the proxy materials must include a separate, nonbinding shareholder vote to approve such agreements and understandings.

Like the say-on-pay provisions, the “say-on-parachute” provisions of the Act are effective for the first annual or other meeting of the shareholders occurring six months after the Enactment Date, authorize the SEC to exempt certain companies (taking into account whether the applicable requirements would disproportionately burden small issuers, among other considerations) and require institutional investment managers to report at least annually how they voted.

Independence of Compensation Committees

Under the Act, each member of a public company’s compensation committee will be required to be a member of its board of directors and independent. However, the compensation committee independence requirements will not apply to controlled companies,[5] limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies registered under the Investment Company Act of 1940 or foreign private issuers that disclose to shareholders why it does not have an independent compensation committee. Both the New York Stock Exchange (“NYSE”) and the NASDAQ Stock Market (“NASDAQ”) already require that executive compensation be reviewed by a compensation committee composed of independent directors (required by the NYSE) or by an independent compensation committee or by a majority of the independent directors (required by NASDAQ).

Under the Act, a covered company’s failure to have a compensation committee comprised only of independent directors will result in the prohibition of the listing of the company’s stock on any national securities exchange or association pursuant to rules to be adopted by the SEC within 360 days of the Enactment Date. Under such rules, a director’s “independence” will be based upon the applicable exchange’s consideration of relevant factors, among them the source of the director’s compensation, including any consulting, advisory or other compensatory fees, as well as the director’s affiliation with the company or its subsidiaries and affiliates.

The Act requires that the SEC rules provide for “appropriate procedures” for a company to have a “reasonable opportunity” to cure any defects that would result in its delisting from the applicable exchange. The Act also requires that the SEC rules permit exchanges to exempt a particular relationship from its independence requirements as the exchange considers appropriate after considering the size of the company, among other factors. Depending on the ultimate nature and scope of these rules, public companies will likely need to separately analyze the independence of directors for purposes of these rules, for purposes of tax deductibility under Section 162(m) of the Internal Revenue Code regarding performance-based pay and for securities law purposes under Section 16(b) of the Securities Exchange Act of 1934 regarding the short-swing profit recovery rules.

With the additional regulation surrounding compensation committee independence requirements, public companies may find that their pool of potential compensation committee directors has shrunk as a result of these new rules.

Compensation Committee Consultants, Legal Counsel and Other Advisers

The Act generally authorizes a compensation committee to retain the services of a compensation consultant, independent legal counsel and other advisers in their sole discretion. The Act also requires companies to provide for appropriate funding for the reasonable compensation of compensation consultants and to independent legal or any other advisers to the compensation committee and confers upon the compensation committee the direct responsibility for their advisers’ appointment, compensation and work.

However, the Act provides that if a compensation committee elects to retain the services of compensation consultants, legal counsel or other advisers, it may only do so after taking into consideration factors to be identified by the SEC as affecting the independence of such advisers.[6] Under the Act, such factors must include:

- the provision of other services to the company by the employer of the consultant, legal counsel or adviser;
- the amount of fees received by the consulting, law or advisory firm as a percentage of its total revenues;

- the policies of the person that employs the consultant, legal counsel or adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel or adviser with a member of the compensation committee; and
- any stock of the company owned by the compensation consultant, legal counsel or other adviser.

Additional factors must be "competitively neutral" among categories of consultants, legal counsel or other advisers and must preserve the ability of compensation committees to retain the services of any such advisers. Hopefully the SEC will clarify the meaning of "competitively neutral" as applied to adviser independence standards when it issues its rules pursuant to the Act.

For meetings occurring on or after the one-year anniversary of the Enactment Date, companies subject to the Act must disclose in their proxy materials whether a compensation consultant's services were retained, as well as whether the consultant's work raised any conflict of interest, in which case it must also describe the nature of the conflict and how the company has addressed it. Disclosure of legal counsel or other advisers is not required. Further, the rules are not intended to affect a compensation committee's ability or obligation to exercise its own judgment in fulfilling its duties or to require a compensation committee to follow the advice or recommendations of the compensation consultant, legal counsel or other adviser.

Like the committee independence requirements, the SEC is required to issue rules prohibiting exchanges from listing any security of a company that is not in compliance with the compensation committee adviser independence requirements within 360 days after the Enactment Date, but must provide for a reasonable opportunity to cure conditions that would otherwise result in the company's listing. Controlled companies are exempted from these requirements, although the Act's consultants and adviser independence provisions do not exclude limited partnerships, foreign private issuers and other entities exempted from the compensation committee independence provisions.

"Pay-for-Performance" and Compensation Ratios Disclosure

The Act directs the SEC to issue rules that will impose two additional executive compensation disclosure requirements for proxy and other materials filed by companies subject to the executive compensation proxy disclosure requirements, although the Act does not indicate when the SEC rules requiring these additional requirements will be issued. First, the rules will require clear "pay-for-performance" disclosure showing the relationship between compensation for a company's named executive officers that was actually paid and the company's financial performance (taking into account any change in value of the stock and any dividends or distributions), and may include a requirement to include performance graphics. The Act does not discuss other financial measures, such as earnings before interest, taxes, depreciation and amortization, return on investments or return on assets. It is unclear whether the SEC will address how these other financial measures might apply in satisfying the disclosure requirement.

Second, the rules will require a company to disclose the median total annual compensation of all employees other than its chief executive officer, the total annual compensation of its chief executive officer and the ratio of such amounts. For this purpose, total compensation includes all components of compensation disclosed in the Summary Compensation Table of a company's proxy statement. While the concept of the ratio is straightforward, the implementation of this rule will likely be difficult and burdensome when considering the compensation of international employees in multiple jurisdictions and business units, as well as determining the value of equity awards, incentive compensation, pension benefits, nonqualified deferred compensation, earnings, perquisites and other forms of compensation provided to an entire workforce. It remains to be seen how the SEC will implement these requirements in a practical manner.

Clawbacks — Recovery of Incentive-Based Compensation

Under rules to be promulgated by the SEC, public companies will be required to develop and implement a policy regarding the recovery of incentive-based compensation paid to executive officers[7] if the company is required to restate its accounting statements as a result of material noncompliance with applicable financial reporting requirements. The SEC will also issue rules addressing the disclosure of a company's clawback policy.

Under the Act, the clawback policy must provide for the recovery of incentive-based compensation (including stock options) received by any current or former executive officer during the three-year period preceding the date on which the company is required to restate its accounting statements as a result of material noncompliance with applicable financial reporting requirements, to the extent such compensation is in excess of what would have been paid under the accounting restatement. Failure to comply with the clawback provisions under the Act will result in the prohibition of the listing of a company's stock on any national securities exchange or association.

The clawback provisions of the Act apply to all current and former executive officers of the company, not just its current executive team. As a result, a former employee who was an executive officer at any time will be subject to the clawback of erroneously paid compensation received within the three years prior to an accounting restatement, regardless of whether the former executive was an executive officer at the time of the restatement or whether the compensation that was "received" during the three-year period may have been earned prior to it.

In addition, the clawback provisions of the Act do not require a nexus between the financial restatement and the actions of the applicable executive officer, such as a showing of misconduct or negligence by the applicable executive. The focus of the Act's clawback provision is on the current or former executive officer's receipt of incentive-based compensation based on erroneous financial data rather than on the executive officer's involvement in the preparation of the company's financial statements. Under the clawback provisions of the Act, it is irrelevant whether the financial restatement is a result of misconduct by anyone for purposes of determining whether compensation must be recouped. While the Act requires a company recoup overpayments made based upon erroneous financial statements, it does not provide for executive officers to receive additional incentive-based compensation that was earned but not paid due to the erroneous financial statements.

The clawback provisions of the Act are broader than those under the Sarbanes-Oxley Act of 2002 which provide that if a company is required to prepare a financial restatement due to material noncompliance of the company, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer must reimburse the company for any bonus or other incentive-based or equity-based compensation received, and any profits realized from the sale of the securities of the issuer, during the year following issuance of the original financial report.

The clawback provisions under the Act also differ from that which was required of institutions who received financial assistance under TARP. Institutions that received financial assistance under TARP are generally required to provide for the clawback of bonuses and incentive compensation awarded to senior executive officers and the next twenty highly paid employees if such payments were based on materially inaccurate financial statements or performance metrics, which, depending on the specific circumstances, may have a broader reach than the Act.

Disclosure of Hedging

The Act directs the SEC to impose disclosure requirements with respect to whether the company permits its employees, directors or their designees to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities granted as compensation or otherwise owned, directly or indirectly, by such employees and directors. The Act does not indicate when the SEC must issue these disclosure requirements or when they will be effective.

Restrictions on Covered Financial Institutions

“Appropriate Federal regulators” are required to prescribe regulations or guidance within nine months following the Enactment Date that:

- require each “covered financial institution” with $1 billion or more in assets to disclose to the regulators the structures of all of its incentive-based compensation arrangements in order to determine whether such arrangements provide excessive compensation, fees or benefits to employees, directors or principal shareholders or could result in material financial loss by the company; and

- prohibit any type of incentive-based compensation, or any feature of such compensation, by a covered financial institution that the regulators determine encourages inappropriate risks by providing any of its officers, employees, directors or principal shareholders with excessive compensation, fees or benefits, or that could lead to material financial loss to the covered financial institution.

The Act defines a "covered financial institution" as a depository institution or depository holding company, a broker-dealer, a credit union, an investment adviser, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and any other financial institution that the appropriate Federal regulators determined should be treated as such, except that financial institutions with less than $1 billion in assets are exempt. For these purposes, "appropriate Federal regulators" include the Board of Governors of 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 Securities and Exchange Commission and the Federal Housing Finance Agency.

Disclosure of Chairman and CEO Structure

Within 180 days after the Enactment Date, the Act directs the SEC to issue rules requiring a company to disclose in its annual proxy statement the reasons why the company has chosen the same person to act as both chairman of the board of directors and chief executive officer, or why the company has chosen different individuals to serve in these roles. This aspect of the Act is an expansion of board leadership structure disclosure requirements issued by the SEC in December 2009 which required disclosure of whether the company has a lead independent director and what specific role the lead independent director plays in the leadership of the board in the event that a single person serves as both chief executive officer and chairman of the board.[8]

Next Steps

The Act requires that the SEC promulgate rules to implement the provisions related to corporate governance and executive compensation. Companies can prepare for the new rules by considering the following:

- *"Say-on-Pay."* The say-on-pay vote is significant despite its advisory and nonbinding nature. Board members should take seriously an unfavorable shareholder vote on executive compensation practices or else potentially find their

board positions at risk in the future. Due to the prohibition on broker discretionary voting (see footnote 1) providing that brokers may no longer vote on executive compensation issues without specific instructions from the beneficial owner of the shares, institutional shareholders may begin to have a greater voice in a company's policies. In anticipation of upcoming say-on-pay votes, companies should review guidelines concerning appropriate executive compensation practices to determine if their current practices may cause shareholders to issue a negative vote. Further, companies should consider retaining proxy solicitation firms to help get their individual shareholders to vote in order to mitigate the effects of the elimination of broker discretionary voting.

- *Independence of Compensation Committee.* The Act calls for increased compensation committee independence. However, given the existing tax, securities and exchange requirements relating to compensation committee independence, it remains to be seen what practical impact the new rules will have. In preparation for the new SEC rules, companies should review whether any possible conflicts exist with respect to their compensation committee members.

- *Independence of Compensation Consultants, Legal Counsel and Other Advisers.* While awaiting SEC rules that clarify the breadth of the independence requirements for compensation consultants, legal counsel and other advisers, companies should begin (or, in certain cases, continue) to evaluate their relationships with such consultants and advisers for potential independence and conflict issues.

- *"Pay-for-Performance."* Because the Act directs the SEC to issue rules requiring a clear relationship between the compensation of named executive officers and the financial performance of the company (taking into account stock performance), companies should begin to compile the relevant data and examine how their financial performance relates to their executive compensation practices. Companies should also consider how to disclose this information, keeping in mind that companies have generally gravitated toward graphical or tabular disclosure to provide transparent disclosure. However, the SEC's rules may require a specific format for disclosure. Companies are advised to keep abreast of the disclosures that are provided by other companies in their peer group.

- *Compensation Ratio.* The Act directs the SEC to require companies to disclose the ratio of the median amount of compensation paid to employees other than the CEO compared to that of the CEO. Companies will need to gather compensation information that includes all components of compensation disclosed in the Summary Compensation Table from their proxy statements. Companies should begin to consider whether they are prepared to collect and analyze such data. Additionally, companies should prepare to justify and explain the factors which contributed to their ratio, particularly if they anticipate results that materially differ

from others in their peer group.

- *Clawbacks*. The Act directs the SEC to develop rules requiring companies to adopt and disclose a clawback policy to recover any excess executive incentive-based compensation that is paid as a result of materially erroneous financial data. It would be advisable, therefore, for companies to review and modify their existing policies, or begin considering the establishment of a corporate clawback policy. Companies should consider getting their executives officers to acknowledge, in writing, the clawback requirements under the Act and agree to repay compensation for which the clawback obligation arises. However, it may be advisable for companies to wait for more detailed guidance from the SEC on this issue before establishing new clawback policies.

[1] The Act is a reconciliation of The Wall Street Reform and Consumer Protection Act introduced by Barney Frank, Chairman of the House Financial Services Committee (D-MA), and passed by the House of Representatives on December 11, 2009, and The Restoring American Financial Stability Act of 2010 introduced by Christopher Dodd, Chairman of the Senate Banking Committee (D-CT), and passed by the Senate on May 20, 2010. Some of the Act's rules, such as the rules on "say-on-pay" and clawbacks, derive from compensation restrictions promulgated under the Troubled Asset Relief Program ("TARP") and the American Recovery and Reinvestment Act of 2009.

[2] This Alert does not address all provisions of the Act that may relate to executive compensation and corporate governance such as the changes involving broker discretionary voting (which generally prohibits brokers from voting brokerage account shares in connection with the election of directors, executive compensation or any "other significant matter" unless the broker has received specific instructions from the beneficial owner of the shares as to how to vote) and proxy access (which authorizes the Securities and Exchange Commission (the "SEC") to issue rules that would require a public company to permit shareholders use of the company's proxy materials to nominate directors of the company).

[3] Under Item 402 of Regulation S-K of the Securities Act of 1933, a company's "named executive officers" include its chief executive officer, its chief financial officer, its three most highly compensated executive officers (other than the CFO and CEO) who were serving as of the end of the last completed fiscal year, and up to two additional individuals with respect to whom disclosure would have been required but for the fact that the individuals were not serving as executive officers as of the end of the last completed fiscal year.

[4] Disclosure of such arrangements is generally required in connection with a corporate transaction for which proxies, consents or authorizations are solicited under Item 5 of Schedule 14A of the Securities Exchange Act of 1934 to the extent the arrangements would create an interest of an executive officer or director in the transaction; however, Schedule 14A nether requires separate approval of such arrangements nor prescribes any specific format for such disclosure.

[5] Under the Act, "controlled companies" are generally defined as listed companies of which more than fifty percent of the voting power is held by a single individual, group or entity.

[6] Under proxy disclosure reform issued by the SEC in December 2009, if a compensation committee (or other board performing a similar function) engaged its own compensation consultant to provide advice regarding the compensation of executives or directors and if that compensation consultant (or its affiliates) provided other services to the company for fees in excess of $120,000 in the company's last completed fiscal year, the company must disclose the fees paid to the compensation consultant for executive and director compensation consulting as well as the aggregate fees paid to the compensation consultant and its affiliates for all other services. The company must also disclose whether the decision to engage the compensation consultant or its affiliates for these other services was made or recommended by management and whether the board or a board committee approved the engagements for these other services. Similar disclosure regarding fees is required if a compensation consultant is engaged by company management. Hopefully the rules to be issued by the SEC will clarify how these rules relate to the requirements under the Act.

[7] Under the Securities Exchange Act of 1934, the term “executive officer” generally includes the president, any vice president of the company in charge of a principal business unit, division or function (such as sales, administration or finance) and any other officer or person who performs a policy making function.

[8] These requirements indicated that companies must disclose why its leadership structure is appropriate given its specific characteristics or circumstances as well as the extent of the board’s role in the risk oversight of the company.

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