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Executive Compensation & Benefits

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Dodd-Frank Act Reforms Executive Compensation and Corporate Governance for All Public Companies

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With the United States Senate's approval on July 15, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) is now expected to be signed into law by President Obama. The Dodd-Frank Act contains a number of significant executive compensation and corporate governance provisions that will apply to U.S. public companies. This alert briefly summarizes the key provisions in these areas and when they become effective.

Executive Compensation Reforms

"Say on Pay" (Section 951). The Dodd-Frank Act adds a new Section 14A(a) to the Securities Exchange Act of 1934 (Exchange Act) that requires companies to include a separate non-binding resolution subject to shareholder vote in their proxy materials approving the executive compensation disclosed in the materials. This "say on pay" shareholder vote must occur in any proxy, consent or authorization materials for a shareholder meeting for which the Securities and Exchange Commission's (SEC) proxy solicitation rules require compensation disclosure. The shareholders can elect to have the "say on pay" vote annually or every two or three years. The frequency of the "say on pay" vote must be determined by a separate shareholder resolution no less than every six years.

The first "say on pay" resolution and vote to determine the frequency of the "say on pay" vote must occur in the proxy, consent or authorization materials for the first annual shareholder meeting occurring after the end of six months after the enactment of this provision. This means that most public companies will be required to initiate these shareholder resolutions during the 2011 proxy season.

The "say on pay" vote is not binding on the company or its board of directors and cannot be construed as (1) overruling any decision made by the company or the board, (2) creating additional or changing fiduciary duties of the company or the board or (3) limiting or restricting a shareholder's ability to make executive compensation proposals for inclusion in the proxy materials. The provision also gives the SEC the authority to exempt companies or classes of companies from the “say on pay” requirements, taking into account, certain considerations, including whether this requirement would disproportionately burden smaller companies.

Golden Parachute Shareholder Vote (Section 951). A new Section 14A(b) to the Exchange Act requires any proxy or consent solicitation materials for a meeting seeking shareholder approval of an acquisition, merger, consolidation or disposition of all or substantially all of the company’s assets to include a separate non-binding shareholder resolution approving certain payments made in connection with the transaction. The materials must contain the following:

- a “clear and simple” disclosure of any agreements or understandings with the named executive officers concerning any compensation (including present, deferred or contingent) that is based on or relates to the transaction being voted on;
- the aggregate total of all compensation that may be paid or payable to each named executive officer (including the conditions for such payments); and
- a separate non-binding shareholder resolution approving these agreements or understandings unless the agreement or understanding was previously subject to a shareholder vote.

This non-binding shareholder vote cannot be construed to overrule any decision of the board or change fiduciary duties of the board (as described for the “say on pay” vote) and the SEC has been granted authority to exempt companies or classes of companies from this requirement.

Additional Disclosure Requirements (Sections 953 and 955). The Dodd-Frank Act amends Section 14 of the Exchange Act to require the SEC to adopt rules requiring companies to disclose the following in their proxy statements:

- a “clear” description of any compensation required to be disclosed by the company pursuant to Item 402 of Regulation S-K, including the relationship between executive compensation actually paid and the company’s financial performance; and
- (i) the median annual total compensation of all employees (excluding the CEO), (ii) the annual total compensation of the CEO and (iii) the ratio of items (i) and (ii); and
- whether any employee or director of the company (or their designees) is permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities of the company that were granted as compensation or otherwise directly or indirectly held by the employee or director.

Clawbacks (Section 954). A new Section 10D to the Exchange Act requires the SEC to direct the national securities exchanges to require companies to implement a policy to “clawback” certain executive payments that were made based on improper financial statements. To be listed on an exchange, the company must:

- disclose incentive-based compensation that is tied to financial information required to be reported under the securities laws; and
- implement a policy to claw back any such compensation (including stock options) that was paid to current or former executive officers during the three-year period preceding the date the company

must prepare an accounting restatement due to material non-compliance with any financial reporting requirements under the securities laws. The clawback would be the amount in excess of what would have been paid to the officer under the accounting restatement.

Compensation Restrictions for Covered Financial Institutions (Section 956). The Dodd-Frank Act directs “appropriate federal regulators” to issue regulations or guidelines (within nine months of enactment) for covered financial institutions to disclose their incentive compensation arrangements. This disclosure is for the regulators to determine whether the compensation structure provides excessive compensation, fees or benefits or could lead to a material financial loss to the covered institution. The regulators must also issue rules to prohibit incentive-based compensation that encourages inappropriate risks at covered institutions. Covered financial institutions includes: bank holding companies, registered broker-dealers, insured credit unions, investment advisors and other financial institutions selected by the appropriate federal regulators.

Corporate Governance Reforms

Risk Committees at Certain Non-Bank Financial Companies and Bank Holding Companies (Section 165). Public non-bank financial companies supervised by the Federal Reserve and public bank holding companies with assets of $10 billion or more must establish a risk committee. The Federal Reserve has discretion whether to extend these requirements to other public bank holding companies. These risk committees will be responsible for the oversight of the enterprise-wide risk management practices of the company and must include:

- such number of independent directors as the Federal Reserve determines appropriate (based on the nature of operations, size of assets and other appropriate criteria), and

- at least one risk management expert having experience identifying, assessing and managing risk exposures of large, complex firms.

The Federal Reserve is to establish rules no later than two years after enactment, with rules to take effect no later than two years and three months after enactment.

Compensation Committee Independence (Section 952). As a listing requirement, the Dodd-Frank Act requires that compensation committee members must be independent. In determining whether a member is independent, the national securities exchanges must consider certain factors including:

- the source of compensation of the member, including any consulting, advisory or other compensatory fee paid by the company and

- whether the member is affiliated with the company, a subsidiary of the company or an affiliate.

Further, the compensation committee will have the sole discretion to hire compensation consultants, legal counsel and other advisors and will be directly responsible for the appointment, compensation and oversight of these advisors.

In selecting such advisors, the committee must consider certain factors affecting independence (to be identified in rules to be issued by the SEC). Companies must provide for appropriate funding of these advisors for payment of reasonable compensation, as determined by the compensation committee. National securities exchanges may exempt certain companies, taking into consideration the size of a company and any other relevant factors. The Dodd-Frank Act also exempts from these requirements a "controlled company" that is more than 50% owned by an individual, group or other entity. Companies will have an opportunity to cure any independence requirement defect that would result in delisting. Under the Dodd-Frank Act, the SEC is to act no later than 360 days after enactment, and the company's proxy statement for any shareholder meeting occurring one year or more after the Dodd-Frank Act's enactment must include disclosure of whether the compensation committee retained a compensation consultant, as well as a discussion of any conflict of interest raised.

Broker Discretionary Voting (Section 957). The Dodd-Frank Act amends Section 6(b) of the Exchange Act to require that the national securities exchanges prohibit proxy voting by a broker who is not the beneficial owner of the security in connection with the election of directors, executive compensation, or any other significant matter, as determined by the SEC, unless the beneficial owner of the security has specifically instructed the broker how to vote.

Proxy Access (Section 971). The Dodd-Frank Act amends Section 14(a) of the Exchange Act by allowing the SEC to issue rules requiring that shareholders have access to a company's proxy solicitation materials to nominate their own director candidates to serve on the board. Additionally, the Dodd-Frank Act authorizes the SEC to exempt certain companies from any proxy access requirements it does adopt, taking into account certain considerations (*e.g.*, whether such requirements disproportionately burden small issuers).

On July 14, 2010, the SEC voted unanimously to publish its Concept Release on the U.S. Proxy System, which is expected to include a 90-day comment period when published, and is part of the first comprehensive SEC review of the infrastructure of the U.S. proxy voting system in nearly 30 years. The concept release focuses on three main issues: (1) the accuracy and transparency of the voting process, (2) the manner in which shareholders and corporations communicate and (3) the relationship between voting power and economic interest.

Disclosures Regarding Chairman and CEO Positions (Section 972). The Dodd-Frank Act amends Section 14(b) of the Exchange Act directing the SEC, within 180 days after enactment, to issue rules requiring listed company proxy statements to disclose why the company has chosen the same individual or two different individuals to serve as chairman of the board of directors and the chief executive officer. Similar disclosure is required under current SEC rules, and it is unclear whether this provision will result in any additional disclosure requirements.

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the authors below.

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