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Financial Reform Law Will Impact Executive Compensation and Corporate Governance Practices

The Senate has just approved the Dodd-Frank Wall Street Reform and Consumer Protection Act, the financial reform legislation previously approved by the House of Representatives. President Obama is expected to sign this legislation into law next week. Along with sweeping financial reforms, the legislation contains provisions that will impact executive compensation and corporate governance practices at publicly-held companies. Public companies are faced with potential de-listing and other penalties for non-compliance. Further, financial firms, whether or not public, will need to adhere to prohibitions on certain pay practices.

Background

Various bills have been introduced over the past several years that would require shareholder votes on executive compensation as well as additional disclosures and restrictions. Until now, none of them made it very far through the legislative process. Now, Congress has approved financial reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act (originally known as the Restoring American Financial Stability Act), which among many other things, includes provisions affecting executive compensation and corporate governance.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act includes many of the executive compensation provisions in prior proposed legislation plus additional requirements that companies will need to comply with. Specifically, the new law will require non-binding shareholder votes on executive compensation, compensation committee and advisor independence, additional disclosures of executive compensation, expanded clawback provisions, and additional restrictions applicable to financial firms.

Shareholder "Say-on-Pay" and "Say-on-Golden Parachutes"

Under the new law, at least once every three years, shareholders of public companies will have to be given an opportunity to vote on the compensation of the company's named executive officers (NEOs). In addition, at least once every six years, companies will have to give shareholders an opportunity to decide whether this vote should occur every one, two or three years.

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The new law will also require nonbinding shareholder votes with respect to compensation paid to NEOs in connection with a corporate transaction such as a merger, acquisition or disposition of assets. For this purpose, additional disclosures that clearly specify the payments will be required.

In addition, under the new law, institutional investment managers will be required to report at least annually how they voted on any required "say-on-pay" or "say-on-golden parachute" votes.

The SEC has the authority to exempt an issuer or class of issuers from the voting requirements. In making this determination, the SEC must take into account the burden that these new requirements may have on small issuers.

> ***BUCK COMMENT.*** *These shareholder voting requirements will be effective for the first proxy filing occurring more than six months following the date of enactment and, therefore, will apply to most 2011 annual proxy filings. While the shareholder vote is not binding, it is unlikely that companies and their boards would not take action to address a shareholder "no" vote given the scrutiny being placed on executive pay in the media and concerns over public perception. Further, a "no" vote can affect other voting matters in which shareholder approvals are required – e.g., new share requests under an equity incentive plan.*

The new law will not allow votes by brokers on the election of a Board member, executive compensation, or any other significant matter as determined by the SEC to be counted unless the broker has been provided with specific voting instructions by the owner of the security.

Independence

The new law will require members of the company's compensation committee to be independent members of the company's board. For purposes of determining "independence," the national securities exchanges and associations are required to consider relevant factors, including the source of a board member's compensation and whether a member of the board is affiliated with the company, a subsidiary or an affiliate. However, the national securities exchanges and associations may exempt a particular relationship from the independence requirements, depending on the issuer's size or other relevant factors.

The new law will also impact compensation committee advisors. Under the new law, a compensation committee can only select consultants, counsel or advisors (collectively "advisor") after taking into consideration factors set forth by the SEC such as –

- whether the advisor provides other services to the company
- the amount of fees received from the company by the advisor as a percentage of the advisor's total revenue
- the conflict of interest policies and procedures of the advisor

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- any business or personal relationships between the advisor and members of the compensation committee
- any stock of the issuer owned by the advisor.

The compensation committee is directly responsible for appointing, compensating and overseeing the work of the advisor.

In addition, proxy materials for an annual meeting occurring on or after one year following the date of enactment will have to disclose whether a compensation consultant was retained, whether the work resulted in any conflicts of interest, and if so, the nature of the conflict and how it was addressed.

> ***BUCK COMMENT.*** *This effectively extends the existing SEC requirements to disclose fees paid to compensation consultants when services other than executive compensation consulting are provided to the company by the same consultant. It goes a step further by requiring committees to evaluate independence factors in determining whether to hire a consultant that may not be "independent." Based on the effective date, this additional disclosure requirement will not impact many 2011 proxy filings.*

Each issuer will have to provide funding, as determined by the compensation committee, for the committee to pay compensation consultants, independent legal counsel or any other committee advisor.

Under the new law, the SEC may direct the national securities exchanges and associations to not list the securities of an issuer who fails to comply with the law's independence requirements. Notably, the independence requirements do not apply to controlled companies (i.e., a publicly-traded company in which more than 50 percent of the voting power is held by an individual, a group, or another public company). In addition, the SEC may allow a national securities exchange or association to exempt a category of issuers from these requirements taking into account the potential impact on smaller issuers.

Executive Compensation Disclosures

Under the new law, proxies and consent solicitation materials for an annual meeting of the shareholders will have to include a clear description of any NEO compensation that is required to be disclosed by the SEC. This description will have to show the relationship between executive compensation *actually paid* and the financial performance of the company. The disclosure may include a graphic representation of the required information.

> ***BUCK COMMENT.*** *The application of this new requirement is not clear. It may require proxies to provide a look-back view on actual amounts paid to the NEOs, including actual amounts realized upon exercise of stock options or vesting of restricted shares. In years of poor company performance (including stock value), added pressure will be placed on companies and their boards to justify high levels of actual pay to the NEOs.*

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Each company will have to disclose each of the following in all SEC required filings –

- the median of the annual total compensation of all employees, other than the CEO
- the annual total compensation of the CEO
- the ratio of the median annual total compensation of all employees, other than the CEO, to the CEO's annual total compensation.

BUCK COMMENT. *If this provision were literally enforced, specific data on an employee-by-employee basis would need to be tabulated, including base salary, bonus earned, grant date fair value of stock option grants and other equity awards, change in pension value and nonqualified deferred compensation earnings, and other compensation. Companies would need to spend a considerable amount of time accumulating compensation data that complies with the rules. Further, there would be extreme practical difficulties where there are multinational locations for which compensation data may be difficult to obtain.*

Clawbacks

The new law will require a company to disclose its policy on incentive-based compensation. When an accounting restatement is required due to material noncompliance with financial reporting requirements, it will have to require recovery of incentive-based compensation paid to a current or former executive officer during the 3-year period before the restatement. The amount of the recovery will be based on the excess of what has been paid to the executive officer over the amount that should have been paid under the accounting restatement.

BUCK COMMENT. *This "clawback" requirement is substantially broader than current Sarbanes-Oxley (SOX) provisions which generally provide for limited clawback provisions only with respect to CEOs and CFOs. While a number of companies have broadened their clawback policies beyond the SOX requirements, there will most likely be a need to expand their scope. Once again, guidance will be needed on how to apply this new requirement. For example, it is not clear as to how a clawback feature would work with respect to a stock option award – e.g., would it be based on the appreciation in the intrinsic value of the award during the period covered by a restatement or would it be based on some other measure? Would non-performance-based awards (e.g., restricted shares) be exempt from this provision?*

Enhanced Compensation Structure Reporting and Prohibitions at Financial Institutions

Under the new law, within 9 months of enactment, the appropriate federal regulators are to prescribe guidance requiring "covered financial institutions" to disclose the structure of all incentive-based compensation arrangements to determine whether the structures result in excessive compensation, fees, or benefits being paid, or could lead to material financial loss to the institution. (A covered financial institution for this purpose includes a depository institution or depository institution holding company, a broker-dealer registered under the Securities

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Exchange Act of 1934, a credit union, an investment advisor under the Investment Advisers Act of 1940, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and any other financial institution determined to be so treated.) Further, within 9 months of enactment, regulators are to issue regulations prohibiting incentive-based payment arrangements that encourage inappropriate risks by financial institutions. These requirements do not apply to covered financial institutions with assets of less than $1 billion or to certain short-term arrangements that are less than 24 months in duration.

In addition to the above, the new law contains certain provisions involving disclosures regarding hedging activities by employees and directors, director elections, and additional disclosures on chairman and CEO structures.

Conclusion

Under the new law, companies and their boards will need to proactively review and assess their executive compensation practices in advance of the effective dates of the new requirements. Buck's consultants are available to help companies throughout this process.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.

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