The Impact of the Dodd-Frank Act on Executive Compensation and Corporate Governance

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). While Dodd-Frank primarily consists of significant and sweeping regulatory reform aimed at the financial sector, it also contains several executive compensation and corporate governance reforms that will apply to most U.S. public companies. These provisions include:

- shareholder voting on executive compensation (“say-on-pay”) and golden parachutes;
- new independence requirements and considerations for compensation committees and their advisers;
- shareholder access to proxy materials to nominate directors;
- executive compensation disclosures of pay-versus-performance and internal pay equity;
- a requirement that companies adopt a policy providing for the recovery of executive compensation in the event of a financial statement restatement (a “clawback policy”);
- disclosure of company policies on hedging of company securities by directors or employees;
- elimination of discretionary voting by brokers on executive compensation and other matters;
- elimination of the requirement for auditor attestation regarding internal controls for non-accelerated filers; and
- revisions to SEC beneficial ownership and Section 16 short-swing profit reporting.

Several provisions of Dodd-Frank will only affect public companies listed on a national securities exchange (i.e., these provisions will not apply to public companies quoted on the OTC Bulletin Board or Pink Sheets), while other provisions will apply to all public companies. To a considerable extent, Dodd-Frank leaves the specifics of the new requirements to rulemaking by the SEC and national securities exchanges. In this LEGALcurrents® we discuss the executive compensation and corporate governance provisions of Dodd-Frank that pertain to public companies and the actions that public companies should take now.

Mandatory Say-on-Pay Voting

Dodd-Frank requires that each public company include a resolution in its proxy statement to approve the compensation of the company’s named executive officers, as disclosed in the company’s proxy statement. Shareholders are entitled to a “say-on-pay” vote at least once every three years. Shareholders are also entitled to a separate vote on the frequency of say-on-pay votes. A separate resolution must be included in the company’s proxy statement at least once every six years to determine whether say-on-pay votes will be held every one, two or three years. The SEC may exempt smaller reporting companies from this requirement.

This provision is effective as of January 21, 2011. Accordingly, public companies are required to include a say-on-pay resolution and a resolution regarding the frequency of the say-on-pay vote in their proxy statements for annual meetings occurring after January 21, 2011.

Although the shareholder vote is advisory, a failure by the compensation committee to respond effectively to a high level of shareholder dissatisfaction with executive compensation may result in a significant number of “withhold” or “against” votes regarding the reelection of members of the compensation committee.
**What to Do Now**

There are several actions to consider now in preparation for the say-on-pay vote next proxy season:

- Simplify and, if necessary, shorten the narrative executive compensation proxy statement disclosure consistent with current SEC rules, including the Compensation Discussion and Analysis (“CD&A”), to make it easier for investors to locate information critical to their say-on-pay decision. One method of accomplishing this is to provide an executive summary of the compensation decisions and actions taken during the prior fiscal year, highlighting any actions taken to move the company towards compensation best practices.

- Provide additional analysis regarding compensation decisions and reducing the length of disclosure describing the compensation process. One area of continued shareholder interest is the correlation between performance and executive compensation. If necessary, companies should consider providing additional analysis regarding how company performance impacted compensation decisions during the year.

- Revise executive compensation programs to remove aspects that may be objectionable to shareholders and adopt provisions that are consistent with best practices. For example, limit perquisites, add hold-through-retirement policies, revise severance and change-in-control provisions and generally ensure that incentive-based compensation programs are correlated with long-term company performance.

- Before the annual meeting, a company should make an effort to reach out to and communicate with its shareholders to address potential shareholder concerns. Such an outreach program will help companies obtain shareholder approval of executive compensation at the annual meeting.

**Shareholder Approval of “Golden Parachutes”**

Under Dodd-Frank, any proxy or consent solicitation material sent to shareholders in connection with a change-in-control transaction must disclose any agreement with the company’s named executive officers concerning compensation that is based on, or related to, a change-in-control transaction. Additionally, such proxy materials must disclose the aggregate compensation that may be paid to, or on behalf of, a named executive officer and any conditions on which it may be paid.

The disclosure must include information regarding any compensation, whether present, deferred or contingent. Furthermore, such disclosure must be made in a clear and simple format in accordance with regulations that will be promulgated by the SEC.

The proxy or consent solicitation must also contain a separate resolution in which shareholders are entitled to vote to approve such compensation agreements, unless such compensation agreements were already voted on as part of a previous say-on-pay shareholder vote. As with the say-on-pay vote, the shareholder vote on such compensation agreements is not binding.

This provision is effective as of January 21, 2011. Accordingly, any proxy or consent solicitation material sent to shareholders in connection with a change-in-control transaction after January 21, 2011 must disclose the required information and a resolution subject to shareholder approval.

**What to Do Now**

In light of this provision, public companies and executive officers should consider establishing, to the extent not already established, change-in-control compensation arrangements in advance, in order for such arrangements to be subject to a say-on-pay vote. Public companies should review any existing change-in-control compensation arrangements to determine whether they are consistent with current best practices and whether they need to be revised. Public companies should also consider undertaking a thorough review of existing change-in-control compensation disclosure, as shareholders may increase their focus on such disclosure.
New Independence Requirements and Considerations for Compensation Committees and their Advisers

Independence of Compensation Committees

Dodd-Frank requires national securities exchanges to adopt listing standards that require the compensation committee of a listed company to be comprised solely of independent directors, as currently required by the New York Stock Exchange listing standards. DodD-Frank requires that such independent determination be based on multiple factors, including the source of a director’s compensation (including any consulting, advisory or other compensatory fee paid by the company to the director) and whether a director is affiliated with the company, the company’s subsidiaries or the company’s affiliates. Other factors may be imposed in the course of the SEC and national securities exchange rulemaking process.

Controlled companies, limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies registered under the Investment Company Act of 1940 and foreign private issuers that disclose to shareholders the reasons why they do not have an independent compensation committee are all exempt from such requirements.

What to Do Now

While many compensation committees already have independent members who would meet the enhanced standards contemplated by Dodd-Frank, in some instances boards of directors will need to reevaluate compensation committee members’ relationships in light of the revised standards. In the event a company does not have a sufficient number of independent directors necessary to serve on the compensation committee under the enhanced listing standard, it may be necessary to increase the size of the board to recruit new independent directors in anticipation of the new listing standard. Although current audit committee members will likely satisfy the independence standards for compensation committee service, boards should consider whether serving on both committees will over-burden the director given the substantial responsibilities of each committee.

Independence of Compensation Consultants and Advisers

Under Dodd-Frank, compensation committees are empowered to retain, appoint, compensate (at the company’s expense) and oversee advisers, including compensation consultants and legal counsel. However, under Dodd-Frank, a compensation committee must take into account several factors in selecting an adviser which relate to that adviser’s independence. Those factors include:

- other services provided to the company by the adviser;
- the amount of fees paid to the adviser by the company as a percentage of the total revenue of such adviser;
- the conflict of interest policies and procedures implemented by the adviser;
- any personal or business relationships between the adviser and any member of the compensation committee; and
- Whether the adviser owns any stock of the company.

The compensation committee retains ultimate authority to determine whether an adviser is independent after taking into consideration the factors above along with any other factors proposed by the SEC or the committee. Under Dodd-Frank, the compensation committee retains sole authority over the decision to retain an adviser and may still retain non-independent advisers. However, if a compensation committee

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1 NASDAQ listing standards require executive compensation decisions to be made by either (i) independent directors constituting a majority of the board’s independent directors in a vote in which only independent directors participate; or (ii) a compensation committee comprised solely of independent directors.
elects to retain a non-independent compensation consultant, the company will be required to disclose in its proxy statement the nature of the conflict and the compensation committee’s rationale for retaining such non-independent compensation consultant. Dodd-Frank requires the SEC to adopt such rules regarding compensation committee independence and independence considerations for compensation committees and their advisers no later than July 16, 2011 and directs the national securities exchanges to prohibit the listing of any company not in compliance with such rules.

**What to Do Now**

In light of these requirements, compensation committee charters should be reviewed to ensure that the compensation committee is vested with direct authority for the appointment, compensation, and oversight of the work of the compensation consultant or other advisers as contemplated by Dodd-Frank. Compensation committees should also consider meeting with current advisers to discuss issues affecting their independence, and adopting policies that are designed to reduce or eliminate potential conflicts of interest with their compensation consultant or other advisers.

**Proxy Access**

Dodd-Frank permits the SEC to adopt rules that give shareholders access to the company’s proxy statement to nominate directors to serve on the company’s board of directors. Dodd-Frank also authorizes the SEC to promulgate rules that set forth the procedures shareholders must follow to have their nominees included in the company’s proxy statement.

The SEC has been granted authority to exempt certain companies or a class of companies from such requirements. As a result, the SEC may exempt smaller reporting companies from this requirement.

Dodd-Frank does not provide a date by which the SEC rules for such disclosure must be issued, but it is anticipated, based on statements by SEC Chairman Mary Schapiro, that the SEC will adopt proxy access rules applicable to the 2011 proxy season.

**Executive Compensation Disclosure of Pay-Versus-Performance and Internal Pay Equity**

**Pay Versus Performance**

Under Dodd-Frank, the SEC is required to promulgate a rule requiring public companies to disclose the relationship between executive compensation actually paid versus the financial performance of the company, as measured by share price appreciation, dividends and distributions. The information may be presented using a graphical representation or a narrative description.

**Ratio of Compensation of CEO and Median Compensation**

The SEC is required to amend Item 402 of Regulation S-K to require additional disclosure of the median annual total compensation of all of the company’s employees, other than the company’s chief executive officer and the ratio of the median annual total compensation of all of the company’s employees (other than the CEO) to the annual total compensation of the company’s chief executive officer.

Compensation committees should begin the process of compiling information regarding pay versus performance and internal pay equity, including pay equity between each subsequent tier of executives at the company and changes to such relationships over time, to gain insight as to what this type of disclosure may reveal about the company’s internal pay practices. It is still uncertain how companies will be required to determine the median compensation of all of their employees (except the CEO) and SEC rules will need to be promulgated to determine which employees are included (part-time employees, employees on medical leave, military leave, etc.) in the calculation of median employee compensation.

Dodd-Frank does not provide a date by which the SEC rules for such disclosures must be issued. As a result, it is not yet clear whether either of these requirements will be applicable for the 2011 proxy season.
**Clawback Policy**

Dodd-Frank requires the SEC to promulgate rules that require each company listed on a national securities exchange to develop and implement a policy regarding the recovery of any incentive-based compensation paid to any current or former executive officer if the company is required to restate its financial statements due to material noncompliance with any financial reporting requirements under the securities laws. Pursuant to such policy, current or former executives who received incentive compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the company is required to prepare the restatement must pay back any incentive compensation in excess of what they would have been entitled to receive based on the restated financial information.

The clawback provision under Dodd-Frank is different from the clawback provision under Section 304 of the Sarbanes-Oxley Act. For example, the clawback under Dodd-Frank applies to all current and former executive officers (not just the CEO and CFO), does not require misconduct to have taken place for the clawback to be effective, and looks back three years rather than twelve months.

Dodd-Frank does not provide a date by which the SEC rules for such disclosures must be issued. As a result, it is not yet clear whether either of these requirements will be applicable for the 2011 proxy season.

Companies should review the features of any existing clawback policy to see if it meets the requirements of Dodd-Frank. During this process companies should also consider whether there are any additional features or triggering events that should be added to a clawback policy to address a company’s particular circumstances.

**Disclosure Regarding Employee and Director Hedging**

Dodd-Frank requires the SEC to promulgate rules that require a company to disclose in its proxy statement whether an employee or director (or their designee) is permitted to purchase hedging instruments (such as prepaid variable forwards, equity swaps, collars or exchange funds) that are designed to offset any decrease in the market value of securities granted as compensation or held, directly or indirectly, by such employee or director.

Dodd-Frank does not provide a date by which the SEC rules for such disclosures must be issued. As a result, it is not yet clear whether either of these requirements will be applicable for the 2011 proxy season.

Companies should consider reviewing their current insider trading policies to determine whether hedging is permitted by employees or directors. If hedging is not prohibited in the insider trading policy, companies should consider revising such policies to prohibit hedging since hedging by executives tends to be viewed negatively by shareholders.

**Broker Discretionary Voting in Executive Compensation Matters**

Dodd-Frank directs the SEC to adopt rules for the national securities exchanges that would prohibit member brokers from voting a customer’s shares with respect to director elections, executive compensation, or any other significant matter (as determined by the SEC), unless the broker receives specific voting instructions from the beneficial owners. Current New York Stock Exchange Rules, as amended in 2009, prohibit discretionary broker voting in the election of directors and on equity-based compensation plans and certain other compensatory plans.

Dodd-Frank does not provide a date by which the SEC rules for such matters must be issued, but it is expected that the SEC will issue new rules before the 2011 proxy season.

The elimination of discretionary broker voting on executive compensation matters will likely make it more difficult for companies to receive the vote necessary to approve say-on-pay and say on golden parachute payments. Companies should consider outreach efforts to institutional and retail shareholders to increase the number of shareholders participating in proxy voting and to educate shareholders about their compensation programs.
Elimination of the Auditor Attestation Report Regarding Internal Controls for Non-Accelerated Filers

Dodd-Frank eliminates the requirement under Section 404(b) of the Sarbanes-Oxley Act for auditors of public companies with market capitalizations of less than $75 million (non-accelerated filers) to attest to such companies’ assessments of internal control over financial reporting. The SEC had delayed imposing this requirement on public companies with market capitalizations of less than $75 million since the adoption of the Sarbanes-Oxley Act. Dodd-Frank also tasks the SEC with studying ways to reduce the burden of Section 404(b) compliance on companies with market capitalizations between $75 million and $250 million.

Beneficial Ownership and Short-Swing Profit Reporting

Dodd-Frank authorizes the SEC to issue rules shortening the period of time within which a Form 3 must be filed in connection with an individual becoming a director, officer or greater than 10% shareholder of a public company. Dodd-Frank also authorizes the SEC to issue rules shortening the period of time within which a Schedule 13D must be filed in connection with acquiring beneficial ownership of more than 5% of a company’s registered securities. The current rules require that a Form 3 and a Schedule 13D must be filed within ten days of the triggering event.

Dodd-Frank does not provide a date by which such rules must be adopted by the SEC.

If you have any questions regarding this LEGALcurrents®, please do not hesitate to contact any member of our firm’s Securities Practice Group or Executive Compensation Practice Group at 585-232-6500.
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