Client Alert.

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The Corporate Governance and Compensation Provisions of the Dodd-Frank Act

By David Lynn

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") includes several important corporate governance and compensation provisions that will impact most public companies. These provisions will:

- expand the disclosure required in the annual proxy statement, particularly in the areas of executive compensation;
- require public companies to solicit advisory votes on executive compensation ("Say-on-Pay") and, in the event of a merger or other extraordinary transaction, certain "golden parachute" payments;
- require listed companies to reconsider compensation committee independence and the use of advisers, such as compensation consultants and legal counsel; and
- require the adoption or revision of certain policies, such as a policy providing for the recovery of executive compensation in the event of a restatement.

Because many of these provisions – including Say-on-Pay – will likely impact the 2011 proxy season, it is important to begin preparing now for all of the new statutory requirements, the SEC's implementing regulations, and new stock exchange listing standards.

SAY-ON-PAY

Beginning with the 2011 proxy season, the Act requires that companies include a resolution in their proxy statements asking shareholders to approve, in a non-binding vote, the compensation of their executive officers, as disclosed under Item 402 of Regulation S-K. A separate resolution will also be required to determine whether this Say-on-Pay vote takes place every one, two, or three years.

Companies need to focus on ensuring that the first Say-on-Pay vote will achieve majority support from shareholders, because the first vote for a company will be viewed as a test of the company's executive compensation policies and programs. Further, the initial vote will set the tone for future votes on Say-on-Pay resolutions, as well as votes on the election of compensation committee members and resolutions to approve equity and non-equity incentive plans.

Companies can start preparing now for the first Say-on-Pay vote by re-evaluating their disclosure practices with respect to the Compensation Discussion and Analysis ("CD&A"), as well as other executive compensation disclosures in the proxy statement. In this regard, it will be important to critically evaluate whether proxy statement disclosures are effective at communicating the rationale and analysis behind executive pay decisions, including through the use of executive summaries in the CD&A.

Further, companies can begin considering more active engagement with shareholders in anticipation of the Say-on-Pay vote, in order to ascertain which elements of the executive compensation policies and program might be of concern to

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institutional investors and proxy advisory services. Following these engagement efforts, it may be necessary for companies to revisit key executive compensation policies, such as policies with respect to perquisites, severance and change-in-control provisions, clawbacks, stock ownership policies and incentive compensation plans and policies.

SAY-ON-GOLDEN PARACHUTE COMPENSATION

If any golden parachute compensation has not been approved as part of a Say-on-Pay vote described above, the Act requires that companies solicit shareholder approval of the golden parachute compensation through a separate non-binding vote at the meeting where the shareholders are asked to approve a merger or similar extraordinary transaction that would trigger the golden parachute payments. The Act requires that any proxy statement used for soliciting the Say-on-Golden Parachute vote must include clear and simple disclosure of the golden parachute arrangements or understandings and the amounts payable.

Companies can now anticipate potential concerns that could arise in the event of a Say-on-Golden Parachute vote and address those issues by reviewing existing employment agreements, change-in-control plans and other arrangements to determine if post-employment compensation provisions need to be revised or limited.

COMPENSATION COMMITTEE INDEPENDENCE

The Act requires that the stock exchanges adopt listing standards providing that the members of a compensation committee meet enhanced independence standards that are comparable to what is required for audit committee members under the Sarbanes-Oxley Act. The new independence standards will direct boards to consider:

- the source of compensation received by a compensation committee member, including whether he or she receives any consulting, advisory, or other compensatory fee; and
- whether the compensation committee member is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

It is possible that other factors could be imposed in the course of the SEC and stock exchange rulemaking process. While many compensation committees already have independent members that would meet the enhanced standards contemplated by the Act, in some instances boards of directors will need to evaluate relationships that compensation committee members have in light of revised listing standards. If a board does not have a sufficient number of independent members necessary to serve on the compensation committee under the enhanced independence standard, it may be necessary to increase the size of the board and recruit new directors in anticipation of the new listing standard.

COMPENSATION ADVISER INDEPENDENCE

The Act requires that listing standards prescribe that a compensation committee may only select compensation consultants, legal counsel, or other advisers after taking into consideration independence standards established by the SEC. The Act requires that these independence factors include:

- the provision of other services by the person that employs the adviser;
- the amount of fees received as a percentage of an entity's total revenue;
- policies and procedures designed to prevent conflicts of interest;
- any business or personal relationship of the adviser with a member of the compensation committee; and

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- any stock of the company owned by an adviser.

The compensation committee must also be vested with direct authority for the appointment, compensation, and oversight of the work of the consultant. As a result, boards will need to revisit the compensation committee charter to reflect these new requirements. Further, some companies are adopting specific policies that are designed to reduce or eliminate potential conflicts of interest with their compensation consultants and other advisers.

Enhanced disclosure will also be required, addressing whether the compensation committee retained or obtained the advice of a compensation consultant and whether the consultant's work raised any conflicts of interest, the nature of any such conflict, and how it was addressed. In December 2009, the SEC adopted rules requiring disclosure of fees paid to compensation consultants when they provide executive compensation consulting and additional services.

NEW DISCLOSURE REQUIREMENTS

The Act requires the SEC to further expand disclosure requirements for proxy statements to address several areas of compensation with respect to employees, executive officers, and directors.

Disclosure of Pay versus Performance. The Act requires that the SEC adopt rules mandating that companies disclose the relationship of the compensation actually paid to their executive officers versus the company's financial performance, as measured by share price appreciation and dividends or distributions. This disclosure may be presented graphically or in narrative form.

Disclosure of CEO Pay versus Median Employee Pay. The Act requires that the SEC adopt rules mandating disclosure of the median annual total compensation of all employees (except the CEO), the annual total compensation of the CEO, and the ratio of the median employee total compensation to the CEO total compensation.

Disclosure of Employee or Director Hedging. The Act directs the SEC to adopt rules mandating disclosure of whether any employee or director (or designee of such persons) is permitted to purchase financial instruments, such as prepaid variable forwards, 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 held directly or indirectly by the employee or director. In light of this new disclosure requirement, it is likely that companies may adopt or revise policies to prohibit the use of hedging transactions, including selling the company's stock short, for all employees and directors. Some insider trading policies already prohibit these transactions. However, such prohibitions are often limited only to hedging by executive officers and directors.

CLAWBACKS

The Act requires that stock exchange listing standards be amended to require that companies adopt a policy providing that, if a company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, it will recover from any current or former executive officer who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the company is required to prepare an accounting restatement, amounts based on the erroneous data, in excess of what would have been paid under the restatement. Additional disclosure will also be required of a company's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws.

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The Act's clawback requirement, along with the increased attention focused on clawbacks arising from the financial crisis, will likely result in the adoption of clawback policies that contemplate more expansive triggering events than what is contemplated in the Act.

OTHER GOVERNANCE PROVISIONS

The Act includes a number of additional corporate governance provisions, including:

- Authorizing the SEC to promulgate proxy access rules, allowing specified shareholders to include director nominees in the company's proxy materials, but not prescribing specific standards for those rules. The SEC proposed proxy access rules last summer, and it is expected that the SEC will adopt final rules this summer.
- Directing the SEC to promulgate rules mandating proxy statement disclosure of the reasons why the company has chosen to have one person serve as Chairman and CEO, or to have different individuals serve in those roles. The SEC amended its disclosure rules in December 2009 to require a discussion of this topic.
- Barring brokers from using discretionary authority to vote proxies in connection with election of directors, executive compensation, or other significant matters, as determined by the SEC.

CONCLUSION

The SEC and the stock exchanges will be adopting a number of new rules and standards in order to implement the requirements discussed above. While the rulemaking process is likely to take some time, it is possible to proactively address many of these issues now, particularly in anticipation of the 2011 proxy season. We will be providing updates as the SEC and the stock exchanges propose and adopt rules and standards under the Act's new requirements.

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