

# Client Alert

July 21, 2010

## Dodd-Frank Wall Street Reform and Consumer Protection Act Signed Into Law

### New Requirements for Say on Pay, Executive Pay Disclosure, and Director Independence Will Affect All Public Companies

The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law on July 21, 2010, is the culmination of Congress's longstanding and controversial efforts to regulate the financial services industry. While focused on Wall Street and heightened consumer protections, the Act also significantly modifies corporate governance and disclosure practices related to executive compensation.

Ultimately, the Act may affect the design of compensation arrangements at *all* public companies. The key pay-related provisions include:

- **Say on Pay/Say on Frequency/Say on Golden Parachutes:** Shareholders get a non-binding vote on executive compensation at least every three years, with investment managers being required to report how they voted. Shareholders will also be asked to vote on whether Say on Pay will occur every one, two or three years. In addition, shareholders get a separate, non-binding vote on all executive change-in-control arrangements in the context of a transaction-related meeting.
- **Mandatory Clawback Policies:** Companies must implement and report policies for recouping payments to current and former executive officers based on financial statements that are subsequently restated. This is an expansion of the Sarbanes-Oxley clawback provisions.
- **Additional Compensation Policy and Governance Disclosures:** New reporting requirements include: (i) the relationship between pay and performance; (ii) internal equity ratios; (iii) policies on the hedging of company securities; and (iv) the rationale for choosing a combined or separate CEO/COB role.
- **Compensation Committee Member Independence and Oversight:** As part of mandatory Committee independence, consideration must be given to outside advisory fees and any other Director affiliations with the company.
- **Compensation Committee Advisor Independence:** Committees must assess the independence of their advisors, based on suggested factors to be articulated by the SEC.
- **Executive Compensation at Financial Institutions:** Expands the reporting and regulation of incentive-based arrangements that may encourage inappropriate risk-taking at covered public and private companies.
- **Elimination of Broker Discretionary Vote:** Brokers may not vote without customer instruction on certain issues, including Say on Pay and Say on Golden Parachute votes.
- **Proxy Access:** SEC is authorized to issue rules permitting shareholder use of proxy solicitation materials to nominate their own Director candidates.

Significantly, the Act will become effective in stages, with few provisions listed above being immediately effective (a detailed chart of implementation dates is located on page 9). The executive compensation and governance provisions of the Act also contain substantial ambiguities, many of which will not be resolved until regulations are adopted. Regulators, particularly the SEC and bank overseers, will enter into an intense period of rulemaking over the next 18 months.

The remainder of this Client Alert details each of these provisions, as well as their practical implications and likely implementation dates.

### **Say on Pay**

#### *Mandatory Advisory Vote on Pay*

After years of proposals and fierce debate, “Say on Pay” will be the law of the land for all public companies. Specifically, shareholders must be given a non-binding advisory vote on the compensation of named executive officers (NEOs), as disclosed in the proxy Compensation Discussion & Analysis (CD&A) and related tables.

**PM&P Observation:** Although Congress did not specify the form of the shareholder resolution on pay, companies should begin thinking immediately about how to formulate the advisory questions in a clear and understandable manner that will help assure a favorable vote. Although the questions should be specifically tailored to company programs, precedents can be found in the proxy statements of about 240 institutions that participated in the Troubled Asset Relief Program (TARP), as well as a handful of others that gave shareholders an advisory vote on executive pay upon shareholder request or did so voluntarily.

#### *Frequency of the Advisory Vote*

In a surprise last minute amendment, the Act incorporated a compromise provision that enables shareholders to determine whether Say on Pay will be voted on annually, biennially or triennially. The first non-binding “Say on Frequency” vote will coincide with the initial Say on Pay advisory vote and will be required at least every six years thereafter.

**PM&P Observation:** While some companies may prefer less frequent advisory votes on pay, institutional investors and proxy advisory firms such as RiskMetrics Group (RMG) may view biannual or triennial voting patterns negatively. Currently, RMG gives companies that put Say on Pay on the ballot a one-year “pass” to correct problematic practices. When it finds a company’s executive compensation program problematic, RMG will initially issue a negative vote recommendation on the Say on Pay proposal (if offered), rather than a negative vote recommendation on Directors or equity plans. We should know more about RMG’s position when its 2011 policies are released in November.

#### *Vote on Golden Parachutes & Related Disclosures*

Shareholders also get a non-binding advisory vote on golden parachutes arrangements for NEOs related to the sale, consolidation or merger of their company. The golden parachute vote at the transaction-related meeting must be separate from the shareholder vote on the transaction itself. However, a separate Say on Golden Parachute vote is not needed for an arrangement that had already been subject to a shareholder vote at an annual meeting under the Say on Pay requirement.

Additional disclosures are also required in the merger-related proxy solicitation materials in a “clear and simple format” including:

- all agreements or understandings with NEOs concerning any type of compensation (whether present, deferred or contingent) related to the transaction;
- the aggregate total of all such compensation that may become payable to each NEO; and
- the conditions under which such payments may be made.

**PM&P Observation:** The legislation defers to the SEC to provide additional guidance (with no specific deadlines) as to exactly what must be disclosed under the Say on Golden Parachute rules. At a minimum, companies should be prepared to disclose a level of information similar to that required under “Potential Payments Upon Termination or Change-in-Control” in the regular proxy statement, but using quantitative estimates as of the proposed merger date, rather than at fiscal year-end.

**Effective Dates.** Companies must provide shareholders with the Say on Pay and Say on Frequency vote at the first annual meeting occurring after January 21, 2011. Thus, these votes will be required at the 2011 annual meetings of most public companies. In addition, in the event of any meeting occurring after January 21, 2011 in which shareholders are voting on a transaction (separate from the annual meeting), shareholders must be given a separate Say on Golden Parachute vote.

**SEC Authorized to Exempt Smaller Issuers from Advisory Votes on Compensation.** The Act instructs the SEC to consider whether the Say on Pay and Say on Golden Parachute requirements disproportionately burden smaller issuers (historically defined by the SEC as those with public float of under \$75 million), and whether it is appropriate to exempt certain companies on this basis. This will be decided once further regulations are issued.

**Institutional Investment Managers Required to Disclose Votes.** The Act requires institutional investment managers to report at least annually how they voted on Say on Pay, Say on Frequency and Say on Golden Parachute votes.

**PM&P Observations:** While the advisory votes are not legally binding and would not override Board decisions, companies will want to protect Compensation Committee members and other Directors from the possibility of receiving less than the requisite vote at their next election, particularly in light of the new prohibition of broker discretionary voting, discussed below. As a result of this provision, we may see the tone of the CD&A transition from strictly analytical to more persuasive in nature in an effort to convince shareholders to approve compensation arrangements. Consider immediate action including:

- Carefully assess the views and concerns of key shareholders and shareholder advisory firms
- Direct investor relations staff to proactively engage these institutions more frequently on executive pay decisions. Please note that the SEC recently issued interpretive guidance which made it clear that Regulation FD (Fair Disclosure) does not prohibit Directors and shareholders from speaking privately in this context

- Focus on how to best explain the company's pay packages and take more seriously than ever continued requests from the SEC for "more analysis" in the CD&A
- Ensure that the link between pay and performance is clearly and accurately explained (itself a new disclosure required by the Act, as discussed below) – particularly the value delivered to shareholders

### **Clawbacks**

Public companies must disclose and implement policies to recover incentive compensation (including stock options awarded as compensation) from current and former executive officers if subsequent accounting restatements occur due to a company's material noncompliance with financial reporting requirements. Executive wrongdoing will not be necessary to trigger the recoupment of pay. The recouped pay must equal the extra amount that was paid on the basis of the erroneous data. Amounts are recoverable for the three-year period preceding the date the company is required to prepare the restatement. The potential penalty for non-compliance is a de-listing from the exchange.

These clawback policies clearly go beyond the clawbacks provided for under Section 304 of the Sarbanes-Oxley Act of 2002 (SOX), which only has a 12-month look back period, covers just the CEO and CFO, and requires misconduct.

***PM&P Observation:*** We have noted that many companies over the past several years have adopted clawback polices that go beyond SOX standards, and in some cases go beyond the standards in the Act (e.g., requiring recoupment even in cases where noncompliance with financial reporting was not present). We have also observed many companies struggling with implementation, design and enforcement of such policies. We believe best practices in this area will develop over the next few years now that clawbacks are a required policy.

***PM&P Observation:*** This provision of the Act also creates many ambiguities, and defers to the SEC to issue rules. For example, it is unclear:

- how the clawback may be applied to compensation awarded to an individual who became an executive officer after grant but before the restatement;
- how the amount to be recouped is determined where compensation was not tied to specific performance metrics; and
- how the three-year look back period applies to options granted, vested and/or exercised during the previous three-year period, and what would be the recoupment value when applicable.

### **Additional Executive Compensation Disclosures**

#### *Pay-for-Performance*

The SEC will adopt rules requiring public companies to disclose in detail the relationship between the compensation actually paid to executives and the company's financial performance (taking into account any changes in stock value, dividends or other distributions). This information, which may include graphics, will be located in the compensation section of the annual meeting proxy statement.

**PM&P Observation:** Because many companies are under the impression that this information is already required to some degree under current CD&A rules, the SEC will need to clarify what additional details are needed. Other questions include:

- whether the analysis is limited to NEOs, or covers all executive officers;
- whether compensation of each executive and/or each component should be aggregated or viewed separately;
- how “compensation” and “financial performance” are defined;
- what period of time is covered (e.g., is it the same as the five-year Performance Graph formerly included in the proxy statement?); and
- when non-cash or deferred compensation is to be valued.

#### *Internal Equity Ratio*

Public companies must disclose:

- the median annual total compensation of all employees (except the CEO);
- the annual total compensation of the CEO; and
- the ratio between the two.

“Total compensation” will be determined using the same SEC methodology applied in determining NEOs’ total compensation in the Summary Compensation Table (i.e., the sum of salary, bonus, non-equity incentives, grant date fair values of equity, and “other”).

**PM&P Observation:** The SEC will need to provide further guidance on this calculation, given ambiguities in the Act that raise serious practical challenges to companies. For example, arriving at the Total Compensation numbers for five NEOs is already a significant disclosure challenge. If read literally, this Act would now require that companies perform similarly extensive analysis on behalf of the *entire* workforce, potentially involving thousands of employees around the world on different payroll systems. We are hopeful that the SEC’s guidance will reduce this potential burden.

**PM&P Observation:** Once these ratios are published in proxy statements, we anticipate comparisons will be made of the calculated ratios within and across industries, with outliers being singled out for public scrutiny. While we anticipate that ratios will vary across industries, depending in part on the differences in workforces (e.g., a low-paid retail workforce versus a highly-paid unionized employee group), we think many of these nuances may be lost in the potential media firestorm over such ratios.

#### *Disclosure of Employee and Director Hedging*

Annual proxy statements will need to disclose whether employees or Directors are allowed to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) to hedge against a decrease in the value of the company’s equity securities granted as compensation or held directly or indirectly by the employees or Directors.

### *Disclosures Regarding Chairman and CEO Positions*

The Act requires disclosure explaining why the company either maintains a separate Board Chair and CEO, or chooses to combine both roles. This new requirement expands slightly on the revised disclosure rules only recently adopted by the SEC. Those revised rules required discussion of the company's leadership structure and its appropriateness, including whether it combined the roles of Chair and CEO and, if so, whether there was a designated lead independent Director.

### **Compensation Committee Independence**

The SEC is directed to adopt Compensation Committee independence standards by July 16, 2011, and to direct stock exchanges to prohibit the listing of any company that does not maintain an independent Compensation Committee. In issuing independence standards, the Act directs the SEC to consider the sources of any additional compensation paid to Committee members (including consulting, advisory or other fees) and whether any Committee members are affiliated with the company, its subsidiaries or affiliates – a similar standard to which Audit Committee members are currently held under SOX. Stock exchanges may exempt certain companies in their discretion from the independence standards, based on their size or other factors.

***PM&P Observation:*** The NYSE (with most NASDAQ companies following a similar approach) currently requires that independent Compensation Committee members cannot receive more than \$120,000 in non-Director related fees from the company. Companies will need to review their Committee membership once regulations are issued to determine if the heightened independence standards disqualify any members. As an ongoing matter, we also recommend that companies continue to regularly evaluate members' independence to ensure compliance with other securities law (Section 16) and tax-related (Section 162(m)) requirements.

### **Compensation Committee Oversight**

The Act affirms the Compensation Committees' authority to hire, pay and oversee compensation consultants, legal counsel and other advisers. Companies must provide appropriate funding, as determined by the Compensation Committee, to compensate those advisers. The Act also makes clear that the Committee is not required to accept or act on the recommendations of any of its outside advisors.

### **Compensation Committee Advisor Independence and Disclosure**

In choosing compensation consultants, legal counsel and other advisers, the Compensation Committee must take into account factors that the SEC will identify as relevant to their independence, including:

- other services provided by the advisor to the company;
- fees received by the advisor as a percentage of total revenue of the advisor's employer;
- the company's policies or procedures designed to prevent a conflict of interest;
- the existence of a business or personal relationship between the adviser and a Compensation Committee member; and
- any company stock owned by the advisor.

The Act clarifies that in determining these factors, the SEC be competitively neutral among different categories of consultants, counsel and other advisors. Advisor independence standards must be issued by the SEC by July 16, 2011.

Effective for proxies related to meetings occurring on or after July 21, 2011, companies must also disclose whether the Compensation Committee retained or obtained advice from a compensation consultant, whether such work caused a conflict of interest and, if so, the nature of the conflict and how it was addressed. The SEC may, in its discretion, exempt a category of issuers (for example, smaller reporting companies) from these requirements.

**PM&P Observation:** These new provisions – which do not exempt grandfathered relationships – will require companies to more strictly review the independence of their outside consultants. The Act is taking a more potent approach to this issue than the more delicate disclosure rules adopted by the SEC in December 2009. Under those standards, companies disclose the role and services provided by compensation consultants, as well as any additional non-executive/Director compensation-related services provided by compensation consultants. If the fees for the additional services exceeded \$120,000 during the past fiscal year, the company must also report the aggregate fees paid for both the compensation consulting and the additional services.

### **Provisions Applicable to Public and Private Financial Institutions**

Appropriate federal regulators will issue regulations or guidelines by April 21, 2011 to require that both public and private “covered financial institutions” with assets of \$1 billion or more disclose to their respective regulators the structure of all their incentive compensation arrangements. The rules will prohibit any incentive arrangements that the regulators determine encourage inappropriate risks by providing excessive compensation, fees, or benefits, or that could lead to material financial loss. Significantly, this rule governs incentive compensation plans not only for executive officers, but also for all employees, Directors and/or principal shareholders.

“Covered financial institutions” as defined in the Act generally includes depository institutions or holding companies, broker-dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac. Regulators include 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 SEC and the Federal Housing Finance Agency.

**PM&P Observation:** This rule appears to add teeth to the Guidance on Sound Incentive Compensation Policies issued in late June by the Federal Reserve, FDIC, OTS and OCC (the Guidance), which took a more principles-based approach.<sup>1</sup> It is also broader than the Guidance in that it extends to Directors and shareholders. The regulations will presumably need to address certain ambiguities, such as how frequently the disclosures will occur (i.e., are they part of the regular regulatory review process, or a separate mandate?), as well as their coordination with the Guidance.

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<sup>1</sup> See our Client Alert at <http://pearlmeyer.com/incentivepayoversight/PMP-CA-FederalReserveJoinsForces-6-10.pdf> for additional details on this Guidance.

### **Elimination of Broker Discretionary Vote**

As of 2010, the NYSE amended its Rule 452, which gave brokers discretionary authority to vote on certain routine matters without instruction from the beneficial owners of the shares, by eliminating such discretionary voting in uncontested Director elections. The Act now goes further, requiring that the exchanges prohibit discretionary broker votes in connection with Board elections as well as executive compensation (presumably including Say on Pay votes) and any other "significant matter" as determined by the SEC.

***PM&P Observation:*** Companies historically have relied on the discretionary authority given to brokers to achieve positive votes. Going forward, it will be increasingly important that companies conduct shareholder outreach in advance of any votes on compensation issues.

### **Proxy Access**

Proxy access marks a major change in corporate governance by opening up the company's virtually exclusive right to nominate Directors, to shareholders. The Act authorizes (but does not require) the SEC to adopt proxy access rules allowing shareholders to use proxy materials to nominate their own Directors. Currently, only the company's candidates to the Board are included in proxy materials, so that shareholders wanting to nominate other candidates face the significant cost of preparing and distributing separate proxy materials on their own, which is for most investors extremely onerous and prohibitively expensive.

The Senate had attempted to limit proxy access by adding a requirement that any shareholders seeking to nominate Directors meet minimum company share ownership thresholds and holding periods. House members resisted the change and the issue ultimately was punted to the SEC to be sorted out. Our previous Client Alert published in June, 2009 summarizes the SEC's most recent position on these issues.<sup>2</sup>

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<sup>2</sup> See <http://pearlmeyer.com/knowledgecenter/alerts/SECsBusySpring-Summer.pdf>.

## Timeline of Implementation and Further Actions

Provision	Effective Dates (Listed chronologically)	Further Action Needed
<b>Broker Non-Vote on Executive Compensation</b>	As of 7/21/10 (subject to SEC transition rules)	SEC to issue transition guidance
<b>Say on Pay, Say on Frequency, Say on Golden Parachutes</b>	Proxy statements for meetings after 1/21/11	SEC to issue rules on Say on Golden Parachute
<b>Financial Institution Excessive Compensation Rules</b>	Rules to be issued by 4/21/11	Appropriate Federal regulators to issue rules
<b>Compensation Committee &amp; Advisor Independence; Committee's Oversight Authority</b>	Effective by 7/16/11	National securities exchanges to issue listing requirements as directed by SEC
<b>Disclosure of Compensation Consultant Conflict of Interest</b>	Proxy statements for meetings occurring on or after 7/21/11	SEC required to issue rules implementing disclosure requirements
<b>Clawback Policy</b>	Not specified – listing requirements will address effective date	National securities exchanges and associations to issue listing requirements; SEC to issue regulations
<b>Pay-for-Performance Disclosure</b>	Not specified – the SEC's rules will address the effective date	SEC required to issue rules implementing this requirement
<b>Internal Equity Ratio Disclosure</b>	Not specified – the SEC's rules will address the effective date	SEC required to issue rules implementing this requirement
<b>Disclosure of Hedging</b>	Not specified – the SEC's rules will address the effective date	SEC required to issue rules implementing this requirement
<b>Disclosure of COB/CEO Roles</b>	Not specified – the SEC's rules will address the effective date	SEC required to issue rules by 1/17/11
<b>Proxy Access</b>	Not specified – the SEC's rules will address effective date	SEC permitted to issue proxy access rules

## Conclusions

The Act's broad efforts to reform executive compensation will make it essential that all public companies (as well as certain private financial institutions) closely reexamine their practices in short order. For example, Say on Pay is certain to be required at all public companies in the upcoming proxy season, requiring that immediate consideration be given by companies to making the best case to shareholders to support current and anticipated executive pay programs and decisions. However, in many areas the Act provides scant or ambiguous instruction, consistently deferring to SEC rule makers to clarify unclear language and vague new precepts. Our future Client Alerts will keep you informed of how these ambiguities are addressed or settled.

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Pearl Meyer & Partners  
*Comprehensive Compensation®*

[www.pearlmeyer.com](http://www.pearlmeyer.com)

**NEW YORK**  
570 Lexington Avenue  
New York, NY 10022  
(212) 644-2300  
[newyork@pearlmeyer.com](mailto:newyork@pearlmeyer.com)

**ATLANTA**  
One Alliance Center  
3500 Lenox Road, Suite 1708  
Atlanta, GA 30326  
(770) 261-4083  
[atlanta@pearlmeyer.com](mailto:atlanta@pearlmeyer.com)

**BOSTON**  
132 Turnpike Road, Suite 300  
Southborough, MA 01772  
(508) 460-9600  
[boston@pearlmeyer.com](mailto:boston@pearlmeyer.com)

**CHARLOTTE**  
3326 Siskey Parkway, Suite 330  
Matthews, NC 28105  
(704) 844-6626  
[charlotte@pearlmeyer.com](mailto:charlotte@pearlmeyer.com)

**CHICAGO**  
123 N. Wacker Drive, Suite 1225  
Chicago, IL 60606  
(312) 242-3050  
[chicago@pearlmeyer.com](mailto:chicago@pearlmeyer.com)

**HOUSTON**  
Three Riverway, Suite 1575  
Houston, TX 77056  
(713) 568-2200  
[houston@pearlmeyer.com](mailto:houston@pearlmeyer.com)

**LOS ANGELES**  
550 S. Hope Street, Suite 1600  
Los Angeles, CA 90071  
(213) 438-6500  
[losangeles@pearlmeyer.com](mailto:losangeles@pearlmeyer.com)

**SAN JOSE**  
2880 Zanker Road, Suite 203  
San Jose, CA 95134  
(408) 954-7399  
[sanjose@pearlmeyer.com](mailto:sanjose@pearlmeyer.com)