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## [The Regulatory March to Reform Executive Compensation Practices Takes Another Step Forward](#)

On July 21, 2010, the President signed into law (Public Law 111-203) the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (the "Reform Act"). The Reform Act implements a sweeping regulatory overhaul of the financial, banking and mortgage industries and also addresses consumer protection. Included in the Reform Act, and which is the subject of this blog, are numerous new laws affecting executive compensation and corporate governance at publicly-held companies.

As we have previously blogged on many occasions (see for example our blogs on [December 18, 2009](#), [October 27, 2009](#), [August 7, 2009](#), [July 22, 2009](#), [July 17, 2009](#), [June 18, 2009](#)) the Obama Administration and various regulators have made clear their intention to pro-actively work to improve the executive compensation practices of publicly-held companies and financial institutions. After months of legislative effort, the Reform Act culminates in advancing several of the reform objectives previously articulated by the Obama Administration (see for example the [Treasury Secretary's June 10, 2009 statement on compensation](#)) by seeking to foster greater:

- Shareholder empowerment;
- Independent decision-making and use of independent advisers;
- Linkage between executive pay and company performance.

Below is a brief overview of provisions in the Reform Act that affect executive compensation and the related corporate governance aspects.

### SHAREHOLDER EMPOWERMENT AND PROTECTION

#### *Shareholder Say on Pay*

- What: (Section 951 of the Reform Act). Proxy statements for annual (and other) shareholder meetings will require a separate shareholder vote on the compensation of a company's named executive officers ("Say on Pay"). Such Say on Pay votes must occur no less frequently than once every three years. Moreover, at least once every six years, shareholders will get to vote on whether the frequency of their company's Say on Pay vote should occur every 1, 2, or 3 years. The Say on Pay vote is not binding on the company and does not overrule decisions made by the company's board of

directors. The Securities and Exchange Commission ("SEC") may exempt certain companies, such as smaller reporting companies, from Say on Pay. Certain institutional investment managers will be required to disclose, at least annually, how they voted on Say on Pay.

- When: The Say on Pay vote and the shareholder vote regarding the frequency of such Say on Pay vote shall be required for a company's first meeting of shareholders occurring after six months after the enactment of the Reform Act.

### ***Shareholder Approval of Golden Parachutes***

- What: (Section 951 of the Reform Act). Proxy statements in which shareholders will be asked to approve a company's acquisition, merger or disposition of all (or substantially all) assets (each, a "Corporate Transaction") will require disclosure of golden parachute arrangements and Corporate Transaction-related compensation for the company's named executive officers along with the triggering conditions for payment of such compensation. The proxy statement will also require a separate shareholder vote on the golden parachute arrangements/compensation unless such arrangements were previously subject to a Say on Pay vote. The golden parachute shareholder vote is not binding on the company and does not overrule decisions made by the company's board of directors. The SEC may exempt certain companies, such as smaller reporting companies, from the golden parachute shareholder vote. Certain institutional investment managers will be required to disclose, at least annually, how they voted on the golden parachute vote.
- When: The shareholder vote approving golden parachutes shall be required for a company's meeting of shareholders (which is being held to approve a Corporate Transaction) occurring after six months after the enactment of the Reform Act.

### ***Shareholder Nomination of Directors***

- What: (Section 971 of the Reform Act). The Reform Act provides the SEC with the authority to establish rules and procedures permitting shareholder nominees for the board of directors to be included in the proxy statement for the election of directors to the board. The SEC may exempt certain companies, such as smaller reporting companies, from such requirements.
- When: No specific time frame is mandated for if/when any SEC rulemaking must occur.

### ***Broker Voting***

- What: (Section 957 of the Reform Act). Brokers holding shares in street name will not be permitted to vote such shares, absent voting instructions received from the underlying beneficial owner, or executive compensation matters, or for the election of directors, or for any other significant matters as determined by SEC rulemaking.

- When: The Reform Act does not expressly state when the broker voting requirement is effective but it could be read to be effective now.

#### ***Disclosure of Employee/Director Hedging***

- What: (Section 955 of the Reform Act). The SEC is expressly directed to adopt rules that companies must disclose in their proxy statement whether employees/directors (or any of their designees) are permitted to purchase financial instruments that are designed to offset decreases in the value of company securities that they hold.
- When: No specific time frame is mandated for when the SEC rulemaking must occur.

#### ***Insider Reporting Under Section 16(a) of the Securities Exchange Act of 1934***

- What: (Section 929R of the Reform Act). The SEC is expressly permitted to adopt rules shortening the time period for when a Form 3 must be filed with the SEC under Section 16(a) for persons who become a director, officer or 10%+ shareholder of a publicly-held company. Currently, a Form 3 must usually be filed within ten days of the reporting triggering date.
- When: No specific time frame is mandated for if/when any SEC rulemaking must occur.

### **GREATER INDEPENDENCE**

#### ***Compensation Committee Members***

- What: (Section 952 of the Reform Act). Other than with respect to controlled companies and certain other exempted entities, the SEC is directed to adopt rules compelling the national securities exchanges to prohibit the listing of companies which do not require that each member of their compensation committee be an independent director. These rules will specify that "independence" must consider various relevant factors such as the source of any compensation paid to a director and whether the director is otherwise affiliated with the company. The SEC may permit the exchanges to exempt certain companies, such as smaller reporting companies, from these requirements.
- When: The SEC is required to issue rules, directing the exchanges to prohibit listing of non-compliant companies, within 360 days of the enactment of the Reform Act.

#### ***Independent Advisers to Compensation Committee***

- What: (Section 952 of the Reform Act). Compensation Committees may only select their consultants, legal counsel or other advisers (each, a "Committee Adviser") after taking into account factors affecting the independence of the potential Committee Adviser as enumerated by SEC rules. These factors shall include, among other things: other services which are provided, amount of fees that

are paid, business or personal relationships, company stock held by the Committee Adviser, and conflicts of interest policies and procedures.

- When: The SEC is required to issue rules, directing the exchanges to prohibit listing of non-compliant companies, within 360 days of the enactment of the Reform Act.

#### ***Compensation Committee Authority to Retain Compensation Consultant and Independent Legal Counsel***

- What: (Section 952 of the Reform Act). Compensation Committees shall have sole and discretionary authority to retain and obtain the advice of a compensation consultant and be directly responsible for their appointment, compensation and oversight. Compensation Committees will not be required to follow the advice of their compensation consultant. For shareholder meetings occurring on or after one year after the enactment of the Reform Act, companies will need to disclose in their proxy statements whether a compensation consultant was retained by the compensation committee and whether the consultant's work raised any conflict of interest and how such conflict was addressed. Similar rules apply with respect to the compensation committee's authority to retain independent legal counsel (or other advisers) except without the proxy statement disclosure requirement. Companies will be required to provide funding to pay for the reasonable compensation of Committee Advisers.
- When: The SEC is required to issue rules, directing the exchanges to prohibit listing of non-compliant companies, within 360 days of the enactment of the Reform Act. However, independent of the timing of the publication of the SEC rules, the requirement to provide disclosure regarding the utilization of compensation consultants and any related conflict of interest appears to be effective for shareholder meetings occurring on or after one year after the enactment of the Reform Act.

#### ***Relationship between Chairman of Board and CEO***

- What: (Section 972 of the Reform Act). Companies will be required to disclose in their annual proxy statements either why the same person is serving as Chairman and Chief Executive Officer or why different persons are serving in such roles.
- When: The SEC is required to issue rules within 180 days of the enactment of the Reform Act.

### **PAY FOR PERFORMANCE**

#### ***Pay versus Performance Disclosures***

- What: (Section 953 of the Reform Act). The SEC is directed to issue rules requiring companies to disclose in their proxy statement the relationship between paid executive compensation and the

company's financial performance. Such disclosure would need to among other things consider a company's stock price changes and dividends.

- When: No specific time frame is mandated for when SEC rules must be issued.

### ***Internal Pay Equity***

- What: (Section 953 of the Reform Act). The SEC is directed to amend their existing executive compensation disclosure regulations to provide that a company's executive compensation disclosures will also need to include the: (i) median annual total compensation of all employees other than the CEO, (ii) annual total compensation of the CEO and (iii) ratio of (i) to (ii). Annual total compensation will be determined in the same way that it is currently displayed in the Summary Compensation Table for named executive officers.
- When: No specific time frame is mandated for when SEC rules must be issued.

### ***Recoupment of Incentive Compensation (Clawback)***

- What: (Section 954 of the Reform Act). The SEC is directed to adopt rules requiring the national securities exchanges to prohibit the listing of companies that do not have a policy: (i) disclosing their policy on incentive compensation which is based on financial statement information and (ii) which, in the event of a financial accounting restatement due to material noncompliance with any financial reporting requirement, would recover from current/former executive officers any incentive compensation (including stock options) that would not have been paid under the restated financials. This recoupment of compensation will apply to any executive officer even if he/she was not personally culpable with respect to the company having to restate their financial information. Incentive compensation provided during the three years prior to the date when the company is required to prepare the accounting restatement would need to be subject to recoupment.
- When: No specific time frame is mandated for when SEC rules must be issued.

### ***Incentive Compensation at Large Banking Institutions***

- What: (Section 956 of the Reform Act). The appropriate Federal regulator(s) will prescribe regulations/guidelines requiring covered banking and financial institutions to disclose the structures of all of their incentive compensation arrangements so that the regulator(s) can determine whether excessive compensation is being provided or whether such arrangements could lead to material financial loss to the institution. There will also be rules established that prohibit incentive-based payment arrangements which encourage inappropriate risk taking. Covered financial institutions with assets of less than \$1,000,000,000 would not be subject to the above requirements.
- When: The Federal regulators must prescribe their rules/guidelines within nine months of the enactment of the Reform Act.

## What Next?

While companies may be already familiar with a number of the tenets promoted by the Reform Act (for example, many publicly-held companies have already voluntarily adopted a clawback policy or conducted a Say on Pay shareholder vote), companies will nevertheless need to ensure that they comply with all of the specific requirements of the Reform Act and the related regulations that will be promulgated by the SEC and other regulators. Companies will therefore want to monitor (and comment on as appropriate) future regulatory actions that are taken in connection with the Reform Act.

Moreover, as we have commented in our prior blogs, companies should regularly evaluate their compensation programs and practices and seek to improve them if/as needed. The Reform Act provides further impetus to continue to perform this important recurring function. In particular, companies may want to consider:

- Reviewing their golden parachute arrangements and determine if such arrangements are appropriate and defensible;
- Preparing to adopt a clawback policy if they do not already have one and companies with a clawback may need to prepare to make modifications to it;
- Examining and perhaps expanding their shareholder communications processes with respect to executive compensation given the enactment of Say on Pay;
- Reviewing their existing Compensation Discussion and Analysis section to ensure that it provides clear and comprehensive disclosure;
- Preparing draft new executive compensation disclosures in anticipation of the expanded disclosure information that will need to be provided.

Companies will also want to review their existing internal systems/processes and governance documents (such as for example, the compensation committee charter and insider trading policy) and determine what modifications may be needed in order to comply with the Reform Act's new governance and executive compensation disclosure requirements.

And, perhaps more importantly, companies and their boards should evaluate their compensation advisers in light of the Reform Act's enhanced independence rules. A company whose compensation committee has retained the services of truly independent compensation consultants and outside counsel presumably can provide executive compensation disclosures that may be more favorably received by shareholders and corporate governance advocates. The inclusion of qualified independent advisers may also result in improved compensation programs which is ultimately the objective of the Reform Act's executive compensation provisions.

If you have any questions regarding this information, please contact [Greg Schick](#) at (415) 774-2988.