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Dodd-Frank Act Means No Summer Vacation for Compensation Committees

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While the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") is largely directed at reforms within the financial services industry, Congress did not miss its opportunity to adopt regulations on corporate governance and compensation practices applicable to all public reporting companies.

Instead of relaxing on sandy white beaches this summer, it is now the time for executives and directors of public companies to begin to prepare for the 2011 proxy season and to put into place appropriate policies and procedures to ensure compliance with the public company requirements set forth in the Dodd-Frank Act. It is also the time for private companies to consider whether or not voluntary compliance with some or all of the governance requirements contained in the Dodd-Frank Act may be appropriate for them as well.

Say on Pay

At the first annual meeting of shareholders held on or after January 21, 2011, public companies must include a separate nonbinding resolution that provides shareholders with the opportunity to approve the compensation of executive officers as disclosed in the proxy statement ("Say-on-Pay"). In addition, at this same 2011 annual meeting, public companies must provide shareholders with the opportunity to determine whether or not the Say-on-Pay vote should occur annually, biennially or triennially. Following the 2011 annual meeting, public companies must provide shareholders with (i) a Say-on-Pay vote at least once every three years and (ii) a vote to determine the frequency of the Say-on-Pay vote at least once every six years.

Participants in the United States Treasury's Troubled Asset Relief Program are familiar with the nonbinding requirements of a Say-on-Pay vote and some companies have voluntarily put forth Say-on-Pay proposals to their shareholders. Other public companies may inquire as to what is the purpose of a nonbinding vote on executive officer compensation which takes into account the entire compensation

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Compensation committees should continually ask the following question in light of the financial condition of the company: Do our compensation practices provide a level of compensation that is appropriate for the executive officer's responsibilities and duties and that appropriately rewards performance without encouraging unnecessary risk?

If the answer to this question is "Yes," then an affirmative Say-on-Pay vote should be readily achieved. If the answer to this question is "No" or "Not sure," then compensation committees should consider redesigning or amending their compensation practices to forestall a "No" Say-on-Pay vote in the future. If a public company's shareholders do vote "No" on executive officer compensation, then its compensation committee should promptly reexamine its compensation practices in their entirety to determine what aspects or levels of compensation may have been considered inappropriate by shareholders and to address the public relations challenge that will undoubtedly follow from such a public display of shareholder disaffection.

Golden Parachute Compensation

The Dodd-Frank Act also requires public companies that request shareholders to approve a merger, acquisition, sale of assets or other comparable transaction, at the same time, to submit to a nonbinding vote the approval of the compensation payments that may be paid or become payable to an executive officer in connection with such transaction unless that compensation was previously submitted to shareholders in a Say-on-Pay vote. The necessity of a separate vote on a public company's golden-parachute payments may encourage a public company to have an annual Say-on-Pay vote (rather than a biennial or triennial vote), so as to decrease the likelihood of having a separate golden-parachute vote at the same time the public company is asking its shareholders to approve an extraordinary corporate transaction.

Independent Compensation Committees and Compensation Consultants

The Dodd-Frank Act provides the statutory basis to require most listed public companies to have compensation committees comprised entirely of independent directors under standards that the Securities and Exchange Commission ("SEC') must adopt. The SEC is charged with identifying the factors for independence, but such factors must include the sources of all compensation paid to a director and any affiliation

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between the director and the public company.

In addition, the Dodd-Frank Act also provides the statutory basis to require that compensation committees of public companies be given the authority to hire compensation consultants, legal counsel and other advisers and to require that any compensation consultant, legal counsel or other advisor be independent under standards that the SEC must adopt. The SEC is charged with identifying the factors that affect the independence of such advisers, but such factors must include (i) the scope of other services provided by the adviser to the public company, (ii) the amount of fees paid by the public company to the adviser relative to the adviser’s total revenue, (iii) conflict-of-interest policies maintained by the adviser, (iv) business relationships between the adviser and any member of the compensation committee, and (ii) stock owned by the adviser in the public company.

Public companies should begin the process now of reviewing their compensation committee charters to ensure that their compensation committees are comprised only of independent directors and have the express authority to hire independent compensation consultants, legal counsel and other advisors. Compensation committees should promptly begin deliberations on whether they should immediately be retaining independent consultants and independent legal counsel in order to have at their disposal the resources necessary to ensure that their practices are consistent with the standards required by applicable law. This includes having appropriate procedures in place to properly administer their compensation programs and having the tools necessary to describe those programs to shareholders under enhanced disclosure requirements.

Incentive Compensation Clawback

The Sarbanes-Oxley Act of 2002 requires the chief executive officer and chief financial officer of a public company to reimburse to the company any bonus or other incentive-based or equity-based compensation received during a 12-month period following the filing of erroneous financial information if that erroneous financial information arose from misconduct and led to an accounting restatement. The Dodd-Frank Act significantly extends the scope of this clawback.

Under the Dodd-Frank Act, the SEC must require all listed companies to have a policy for the clawback of ANY incentive compensation received by ANY current or former executive officer during the three-year period preceding the date on which the public company is required to prepare the accounting restatement, whether or not there was misconduct. Accordingly, compensation committees must ensure that they have a clear clawback policy in place and that such policy applies to all executive officers. Compensation committees must further ensure that their compensatory plans and agreements pursuant to which incentive compensation is paid clearly provide for the clawback so that executive officers are contractually bound to such commitments.

New Disclosures

The Dodd-Frank Act reinforces compensation-related disclosures already required by the SEC for most public companies and adds some additional layers of disclosure, including a requirement to disclose (i) the median of the annual total compensation of all employees of a public company, excluding the compensation of the chief executive officer; (ii) the annual total compensation of the chief executive officer; and (iii) the ratio of the annual total compensation of all employees (other than the chief executive officer) to the chief executive officer's annual total compensation. The requirement to compare the chief executive officer's annual total compensation to the annual total compensation of all employees appears to serve little benefit in an analysis of the appropriateness of the chief executive officer's total compensation, but it does serve as a reminder that a compensation committee must be in a position to clearly articulate the reason and rationale for compensatory payments to the company's top executive officer.

Next Steps

In place of more normal rest and relaxation this summer, compensation committees should use this time to put the pieces in place to ensure a smooth 2011 proxy season and full compliance with the Dodd-Frank Act. This includes (i) strategizing with outside counsel to determine the best approach to Say-On-Pay, (ii) close analysis of compensation practices and policies to ensure that policies appropriately reward performance without undue risk, (iii) review of the composition of the compensation committee and the compensation committee charter and (iv) the adoption or refinement of policies relating to clawback of incentive-based compensation.

Although the provisions of the Dodd-Frank Act discussed above are applicable only to public companies, private companies should consider whether to adopt some or all of the governance and compensation-related practices to the extent practicable. In consultation with legal counsel, private companies also should consider, among other things, (i) the establishment and membership of a compensation committee, (ii) the appropriateness of compensation-driven incentives and corrective clawbacks and (iii) allowing stockholders a say on executive compensation. Private companies have the advantage of being able to adopt such measures only in circumstances where they make sense.

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