Alert 10-182

Dodd–Frank Wall Street Reform and Consumer Protection Act: Financial Reform and New Executive Compensation Rules

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("the "Dodd-Frank Act" or "Act") was signed into law July 21, 2010 by President Obama, to promote the financial stability of the United States by improving accountability and transparency in the financial system. To that end, the Dodd-Frank Act reforms the U.S. financial regulatory system, but its provisions also apply beyond the financial sector. Most public companies will be affected by the Act, which includes a number of substantive requirements and enhanced disclosure obligations relating to executive compensation practices.

Accordingly, public companies should begin reviewing the upcoming changes and possible approaches for meeting the new requirements. Although many of the new provisions require that the Securities and Exchange Commission ("SEC") establish new rules, amend current Item 402 of Regulation S-K ("Item 402"), or direct national security exchanges or associations to establish new rules before becoming effective, it is widely anticipated that the SEC will have taken necessary action for the rules to be effective by the upcoming proxy season.

The following is a brief description of the Dodd-Frank Act's most significant rules relating to executive compensation practices:

Shareholder Voting

Effective for the proxy or consent solicitation materials for the first shareholder meeting held on or after January 21, 2011 (*i.e.*, six months after the Act's enactment date), the following items must be included:

- Shareholder Say-on-Pay. A separate nonbinding resolution asking for shareholder approval of Named Executive Officer ("NEO") compensation. These "say-on-pay" shareholder votes must take place every one, two or three years. The frequency of the say-on-pay vote is determined by shareholders as well – at least every six years, the company's annual proxy statement must include a separate resolution to determine how frequently the "say-on-pay" votes will occur.
- Shareholder Votes on Golden Parachutes. For proxies or consent solicitation materials for a meeting at which shareholders are asked to approve an acquisition, merger, consolidation or proposed disposition of all or substantially all of a company's assets, (1) disclosure of (i) any agreements or understandings that the soliciting person has with any NEO of the issuer concerning any compensation that is based on or otherwise relates to the transaction being voted on and (ii) the aggregate total of all compensation that may be paid or payable to that officer and the conditions under which it may be paid or payable, and (2) a separate nonbinding shareholder vote to approve any such agreements, understandings and compensation, unless the agreements or understandings were subject to an earlier nonbinding say-on-pay vote.

While these shareholder votes are not binding on the company or its board, and do not create any additional fiduciary duties, they are powerful opportunities for shareholders to voice their opinions, and failure to receive shareholder approval could mean difficulty in re-electing compensation committee directors the following year.

The Act also provides limits on brokers' voting of shares that they do not beneficially own. Currently, under most stock exchange rules, brokers may vote shares for which they have received no instructions, but only on "routine" matters. Generally, matters such as equity plan approvals and, since the New York Stock Exchange Rule 452 changes last year effective January 2010, uncontested director elections, have been considered non-routine. Under the Act, the NYSE Rule

452 change has been codified in the Exchange Act. The national securities exchanges must prohibit brokers from voting shares in certain circumstances: in any election of directors (other than an uncontested election for an investment company), on executive compensation matters (such as say-on-pay and golden parachute votes), and other "significant" matters that will be determined by SEC rulemaking. As historically broker voting has been company-friendly, public companies should consider this additional hurdle when thinking about their executive compensation disclosures and the upcoming say-on-pay vote.

Enhanced Independence Requirements

To date, national securities exchanges have had their own independence requirements for compensation committee members. Under the Act, independence requirements also have been added to the Securities Exchange Act of 1934. No later than July 16, 2011, the SEC will have issued rules and directed the national securities exchanges and associations to prohibit the listing of securities of any issuer that does not meet these requirements, subject to a cure period. However, the national security exchanges are permitted to exempt certain individuals and/or relationships from this independence requirement, and the following entities are exempt: limited partnerships, companies in bankruptcy, open-ended management investment companies, certain foreign private issuers, and "controlled companies" (*i.e.*, an issuer listed on a national securities exchange/association that holds an election for the board of directors, in which more than 50 percent of the voting power is held by an individual, a group, or another issuer).

- Independent Compensation Committee. Compensation committees will be required to include *only* "independent" directors. The SEC rules will take into account relevant factors, including: (i) the sources of compensation for each compensation committee member, including any consulting, advisory, or other compensatory fee paid by the company, and (ii) whether the board member is affiliated with the company, or a subsidiary or affiliate of the company.

- Independent Compensation Consultants, Legal Counsel and Advisers. Compensation committees are permitted, in their sole discretion, to hire compensation consultants, legal counsel and other advisers, provided that the committee considers "independence" prior to hiring. The compensation committee is directly responsible for the appointment, compensation, and oversight of such individuals/entities.

  Particular "independence" factors for the committee's consideration will be identified by the SEC, but will include: (i) whether other services are provided to the company by the consultant, legal counsel, adviser, or entity that employs such individual (the "Consulting Firm"), (ii) the amount of fees received from the company by the Consulting Firm, as a percentage of such entity's total revenue, (iii) any policies of the Consulting Firm designed to prevent conflicts of interest, (iv) any business or personal relationship of the consultant, legal counsel or adviser with a member of the compensation committee, and (v) any company stock owned by the consultant, legal counsel or adviser.

- Compensation Consultant Disclosures. For any shareholder meeting on or after July 21, 2011, company proxy or consent solicitation materials must disclose, in accordance with SEC regulations: (i) whether the compensation committee has used the advice of a compensation consultant, and (ii) whether the work of the compensation consultant raised any conflicts of interest and, if so, the nature of the conflict and how it is being addressed.

- Funding. The SEC must also issue rules that require compensation committees to have authority to engage and funds to pay independent consultants, legal counsel and advisors.

New Executive Compensation Disclosures

Public companies are already required under Item 402 to discuss performance-based compensation practices and internal pay equity in their proxy statements. Under the Act, the new rules require even more specific, quantitative disclosures. The SEC is directed to adopt or amend their rules to require the following additional disclosures in an issuer's annual proxy statement or consent solicitation materials:

- Pay for Performance. A clear description of the relationship between executive compensation actually paid and the financial performance of the company, taking into account the change in the value of the issuer's shares, dividends, and distributions. This disclosure may include a graphic representation. As this type of information is already required to be described generally, it is uncertain how much additional disclosure this change will require.

- Internal Pay Equity. (i) The *median* of "annual total compensation" of all employees other than the CEO, (ii) the "annual total compensation" of the CEO, and (iii) the ratio of the two amounts. For this purpose, "total compensation" is determined under the Item 402 rules in effect on July 20, 2010. This calculation is expected to be perhaps one of the most administratively difficult requirements under the new rules.

- Disclosure of Employee or Director Hedging. Whether company employees, board members, or designees of such individuals are permitted to purchase financial instruments designed to hedge or offset decreases in the market value of company stock that (i) was granted to the employee or board member as compensation, or (ii) is otherwise held (directly or indirectly) by the employee or board member.

Claw-back Provisions

Under the Act, the SEC will direct the national securities exchanges and associations to prohibit the listing of any equity security of an issuer, unless the issuer adopts and implements a qualifying claw-back policy. In the event of an accounting restatement because of material non compliance with financial reporting requirements under the securities laws, the claw-back policy provides that the issuer will recover compensation paid to current or former executives in the three-year period preceding the date on which the issuer is required to prepare a restatement. The policy must provide that the issuer shall recover any amount that exceeds that which would have been paid to the executive after giving effect to the restatement. In addition, disclosure of the issuer's policy on incentive-based compensation based on financial information is required to be disclosed under the federal securities laws.

Enhanced Compensation Oversight for Financial Industry

By April 21, 2011, federal regulators must jointly establish rules requiring "covered financial institutions" to disclose the structures of all incentive-based compensation arrangements to the appropriate federal regulator. The disclosures must be sufficient to determine if such structure: (i) provides an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits, or (ii) could lead to material financial loss to the covered financial institution. Certain types or features of incentive-based compensation arrangements will be prohibited if they are considered to encourage inappropriate risks by covered financial institutions by doing either of the above.

Covered financial institutions must have at least $1 billion in assets for the requirements to apply. The following entities constitute "covered financial institutions": (i) a depository institution or depository institution holding company; (ii) registered broker-dealers; (iii) registered investment advisers; (iv) credit unions; (v) the Federal National Mortgage Association; (vi) the Federal Home Loan Mortgage Corporation; and (vii) any other financial institution that the appropriate federal regulators jointly determine should be treated as a covered financial institution for this purpose.

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If you have any questions regarding executive compensation implications of the Dodd-Frank Act or any other relevant issues, please contact one of the Reed Smith attorneys listed below, or the Reed Smith attorney with whom you regularly work.

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