THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 44 No. 1 January 5, 2011

# THE EXECUTIVE COMPENSATION PROVISIONS OF THE DODD-FRANK ACT

*The reform act provides for say-on-pay and say-on-golden-parachute shareholder advisory votes and enhanced independence for compensation committees and their advisers. It also requires new disclosures relating executive compensation to corporate performance and to median employee compensation, mandates clawbacks, and directs regulators to craft rules prohibiting incentive pay arrangements that create excessive risks for financial institutions. The act becomes effective in stages, starting in 2011.*

By Mark A. Borges *

Although the Dodd-Frank Wall Street Reform and Consumer Protection Act,[1] which was signed into law by President Barak Obama on July 21, 2010, is primarily devoted to reforming the financial services sector, it also contains a number of significant provisions related to executive compensation matters.[2] Individually, several of these provisions are expected to dramatically alter the executive compensation landscape as they expand the influence of shareholders to shape executive pay programs. Collectively, the provisions represent the most significant overhaul of executive compensation policies and practices in a generation.

Reflecting their diverse origin and varied effective dates, compliance with the executive compensation provisions of the Dodd-Frank Act will take place gradually over the next 18 months. In September, the SEC published a schedule for its myriad rulemaking projects under the Dodd-Frank Act[3] which, in the case of the executive compensation provisions, indicates that the provisions will be implemented in two stages:

[1] Public Law 111-203 (July 21, 2010).

[2] Two of the provisions of the Dodd-Frank Act, Sections 951 and 952, trace their origin to H.R. 4173, the "Wall Street Reform and Consumer Protection Act," which was introduced in the 111th Congress by Representative Barney Frank (D-MA). Five of the provisions, Sections 953(a), 954, 955, 956, and 957, were first introduced in the 111th Congress by Senator Christopher J. Dodd (D-CT) as part of his amendment to H.R. 4173, the "Restoring American Financial Stability Act of 2010." The remaining provision, Section 953(b), was contained in S. 3049, the "Corporate Executive Accountability Act of 2010," which was introduced in the 111th Congress by Senator Robert Menendez (D-NJ) in response to his concerns about excessive executive compensation.

[3] *See Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act – Upcoming Activity at* http://www.sec.gov/spotlight/dodd-frank.shtml.

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**RSCR Publications LLC** Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (866) 425-1171 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@hotmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. Copyright © 2011 by RSCR Publications LLC. ISSN: 0884-2426. Reproduction in whole or in part prohibited except by permission. All rights reserved. Information has been obtained by *The Review of Securities & Commodities Regulation* from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, *The Review of Securities & Commodities Regulation* does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions, or for the results obtained from the use of such information.

- The provisions requiring shareholder advisory votes on executive compensation and golden-parachute compensation matters will be implemented first, consistent with their January 21, 2011 effective date,[4] and thus will be in effect for the 2011 proxy season.[5]

- The remaining provisions will be effective upon the completion of SEC (and, in some instances, national securities exchange and national securities association) rulemaking, which, based on the SEC's published schedule for its Dodd-Frank Act rulemaking, will likely delay their effectiveness until late 2011 or the 2012 proxy season.[6]

Nonetheless, given the potential scope and impact of these provisions, it will be incumbent on companies and their boards of directors to use the next several months to familiarize themselves with the rules, understand what will be required to comply (and what remains to be decided), and prepare to take action to incorporate the new requirements into their existing program review and disclosure processes. This article summarizes the principal features of each of the executive compensation provisions of the Dodd-Frank Act. It also highlights the key compliance issues that remain outstanding and suggests various action items to help streamline transition to the new requirements.

## SECTION 951 – SHAREHOLDER APPROVAL OF EXECUTIVE COMPENSATION

### *General Advisory Vote on Executive Compensation*

The key executive compensation provision of the Dodd-Frank Act (at least for the 2011 proxy season) is the shareholder advisory vote on executive compensation – a requirement that was first introduced in Congress several years ago and which has been part of virtually every proposed executive compensation reform ever since.

Section 951 of the Dodd-Frank Act added Section 14A(a)(1) to the Securities Exchange Act, which, generally, requires issuers to include a resolution in their proxy materials for their annual meetings of shareholders asking shareholders to approve, in a non-binding vote, the compensation of their executive officers, as disclosed under Item 402 of Regulation S-K[7] (the "say-on-pay vote"). This must be done at least once every three years.[8] As the provision makes clear, the say-on-pay vote is non-binding on a company and its board of directors, and specifically may not be construed as overruling a decision by the company or its board of directors, creating or implying any change in or additional fiduciary duty for the company or the board, or restricting or limiting the ability of shareholders to

[4] As stated in new Section 14A of the Securities Exchange Act, the advisory votes required by Section 14A(a) are applicable to the first annual meeting of shareholders occurring on or after January 21, 2011, and the advisory vote required by Section 14A(b) is applicable to a meeting of shareholders at which shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of the issuer occurring on or after January 21, 2011.

[5] Consistent with this schedule, on October 18, 2010, the SEC issued proposed rules to implement the shareholder advisory votes on executive compensation and golden-parachute compensation. *See* Securities Act Rel. No. 9153, *Shareholder Approval of Executive Compensation and Golden-Parachute Compensation* (October 18, 2010) (the "Proposing Release").

[6] Section 952, which addresses compensation committee independence matters, provides that, no later than July 16, 2011, the SEC must, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of this section. Exchange Act §10C(f). Each of the remaining executive compensation-related provisions is effective only upon the completion of SEC rulemaking.

[7] 17 CFR §229.402.

[8] *See also* Proposed Exchange Act Rule 14a-21(a), which would specify that the say-on-pay vote is required only when proxies are solicited for an annual meeting of security holders at which directors will be elected, or a special meeting in lieu of such annual meeting, which is when disclosure of executive compensation pursuant to Item 402 of Regulation S-K is required.

make proposals for inclusion in proxy materials relating to executive compensation.[9]

*Proposed Rules*

While the say-on-pay vote requirement itself is fairly straightforward and self-executing (that is, it doesn't require SEC rulemaking to implement), there are several interpretive matters relating to Section 14A(a)(1) which the SEC has addressed in the proposed rules that it published for comment on October 18, 2010. The first concerns whether the requirement to include a separate resolution providing for a say-on-pay vote in a company's proxy materials requires the filing of a preliminary proxy statement. Currently, Exchange Act Rule 14a-6(a)(7)[10] does not require the filing of a preliminary proxy statement in connection with an advisory vote on executive compensation in the case of a participant in the federal government's Troubled Asset Relief Program ("TARP").[11] Since the policy reasons for this exemption apply equally in the case of the general say-on-pay vote, the SEC has proposed an amendment to Exchange Act Rule 14a-6 to provide that the general advisory vote on executive compensation required by Section 14A(a)(1) does not trigger the requirement to file a preliminary proxy statement.[12]

A second matter concerns the form of the resolution itself. The SEC has indicated that companies will not be required to use any specific language or form of resolution in soliciting shareholder input on their executive compensation.[13] The say-on-pay vote resolution, however, must relate to all of the executive compensation disclosure set forth pursuant to Item 402 of Regulation S-K (the Compensation Discussion and Analysis, the compensation tables, and the other narrative disclosure accompanying the compensation tables).[14]

The SEC is also proposing amendments to Item 402(b) of Regulation S-K to require companies to address in their Compensation Discussion and Analysis whether and, if so, how their compensation policies and decisions have taken into account the results of their say-on-pay votes. While this disclosure requirement has been framed to require a discussion of responses to prior say-on-pay votes on a cumulative basis, the SEC has solicited comment as to whether the requirement should be limited solely to the most recent say-on-pay vote.[15]

Finally, because a Compensation Discussion and Analysis is not required under Item 402 of Regulation S-K for smaller reporting companies,[16] the SEC has confirmed that the say-on-pay vote requirement does not alter this position.[17]

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[9] Exchange Act §14A(c). *See also* Proposed Item 24 to Schedule 14A, which would require disclosure in a company's proxy statement for an annual meeting (or other meeting of shareholders for which executive compensation disclosure pursuant to Item 402 of Regulation S-K is required) of the fact that a separate shareholder vote on executive compensation is being provided and a brief explanation of the general effect of the vote, such as whether the vote is non-binding.

[10] 17 C.F.R. §240.14a-6(a)(7).

[11] Section 111(e)(1) of the Emergency Economic Stabilization Act of 2008 ("EESA") (12 U.S.C. §5221(e)(1)).

[12] Proposed amendment to Exchange Act Rule 14a-6(a)(7).

[13] Proposing Release at Section II.A.1.

[14] Consistent with Section 14A, the compensation of directors is not subject to the say-on-pay vote. Nor is the disclosure about a company's compensation policies and practices as they relate to risk management and risk-taking incentives, except to the extent that risk considerations are a material aspect of a company's compensation policies or decisions for named executive officers (where such information would be included as part of the Compensation Discussion and Analysis). Instruction 1 to Proposed Exchange Act Rule 14a-21. If a company includes disclosure of golden-parachute compensation arrangements in an annual meeting proxy statement, however, such disclosure would be subject to the say-on-pay vote. Instruction 2 to Proposed Exchange Act Rule 14a-21.

[15] Proposed Item 402(b)(1)(vii); *see also* the Proposing Release at Section II.A.3.

[16] Proposing Release at Section II.A.3. A "smaller reporting company" is defined in Item 10(f)(1) of Regulation S-K.

[17] Instruction 3 to Proposed Exchange Act Rule 14a-21. Section 951 of the Dodd-Frank Act gives the SEC authority, by rule or order, to exempt an issuer or class of issuers from the advisory vote requirements of Section 14A(a), expressly stating that, in determining whether to grant an exemption, the SEC is to take into account whether the advisory vote "disproportionately burdens small issuers." Exchange Act §14A(e). The Commission has indicated, however, that because the shareholder advisory votes and additional disclosure required by Section 14A would be significant for investors in all companies, including smaller reporting companies, it does not intend to exercise this authority. Proposing Release at Section II.E.

*Action Items*

In spite of two years of say-on-pay votes by TARP recipients and nearly 60 voluntary votes in 2010, it's too early to tell what this new requirement portends for companies. Those with a history of problematic pay practices, as identified by the major proxy advisory firms or their large shareholders, or recent poor financial performance, or those that are embroiled in an ongoing dispute with shareholders may be at risk for a high "no" vote count or a rejected resolution.[18] Also, there will be some reputational risk for companies in 2011– and their boards of directors and compensation committees –as the media and shareholder activists focus on the results of most companies' initial say-on-pay vote.

In addition, it's not clear how the prohibition on broker voting of uninstructed shares in executive compensation matters mandated by Section 957 of the Dodd-Frank Act[19] will impact the say-on-pay vote.[20] Finally, Section14A(d) requires every institutional investment manager subject to Section 13(f) of the Exchange Act[21] to report at least annually how it voted on the new say-on-pay vote, potentially changing voting decisions that previously may have been solidly in management's corner. Consequently, companies should take the vote seriously in 2011.

Accordingly, in preparing for the initial say-on-pay vote, companies should consider the following actions:

- addressing any lingering concerns about their executive compensation program, to the extent that an existing pay policy or practice is objectionable to one or more of the major proxy advisory firms or an institutional investor, or where the compensation committee is considering installing a new "best practice";
- reviewing their current executive compensation disclosure to see whether it should be improved, such as by adding an executive summary or making greater use of graphics to convey their key compensation messages; and
- analyzing their shareholder base to determine whether the absence of broker voting of uninstructed shares will have any impact on the outcome of the vote.

### *Advisory Vote on the Frequency of the Say-on-Pay Vote*

In an 11th-hour surprise, the House-Senate conferees on the Dodd-Frank Act dropped the requirement for an annual say-on-pay vote and, instead, agreed that each company's shareholders be given the opportunity to decide for themselves whether to conduct a say-on-pay vote annually, biennially, or triennially. Accordingly, Section 14A(a)(2) of the Exchange Act requires that, not less frequently than once every six years, issuers include a resolution in their proxy materials for their annual meetings of shareholders asking shareholders whether the general vote on their executive compensation program should take place every one, two, or three years (the "frequency vote").[22]

*Proposed Rules*

There are two key interpretive matters presented by the frequency vote requirement, the most significant of which involves the structure and effect of the vote itself. First, Section 14A(a)(2) does not indicate whether the frequency vote is to be a choice between the three alternatives set forth in the provision or whether a company can recommend a specific approach (for example, every three years) for approval or rejection by shareholders. This dilemma is complicated by the proxy rules themselves which provide that, in the case of a matter being submitted for shareholder action, the person being solicited is to be afforded an opportunity to specify by boxes a choice between approval or disapproval of, or abstention with respect to, each separate matter referred to therein as intended to be acted upon (other than with respect to director

[18] During the 2010 proxy season, at least three companies – Motorola, Inc., Occidental Petroleum Corporation, and KeyCorp. – saw their shareholders reject their executive compensation programs through a say-on-pay vote.

[19] *See* discussion of Section 957 below.

[20] In Section II.C.2 of the Proposing Release, the SEC confirms that Section 957, and the related rule changes of the national securities exchanges, apply to the shareholder advisory votes on executive compensation.

[21] 15 U.S.C. §78m(f) (2010). Section 13(f) requires institutional investors that exercise investment discretion over $100 million or more of SEC-identified exchange-traded equity securities and certain other securities to publicly disclose their securities holdings.

[22] *See also* Proposed Exchange Act Rule 14a-21(b), which would specify that the frequency vote is required only when proxies are solicited for an annual meeting of security holders at which directors will be elected, or a special meeting in lieu of such annual meeting, which is when disclosure of executive compensation pursuant to Item 402 of Regulation S-K is required.

elections).[23] Thus, absent a rule change, the former approach is not feasible. In addition, in several jurisdictions, state corporate law requires a majority vote for approval of a matter submitted for shareholder action – a hurdle that may limit the ability of many companies to set the standards for voting on specific resolutions.[24]

This issue is further complicated by the effect of the vote. Section 14A(c) expressly states that the frequency vote is not binding on the issuer or its board of directors and, among other things, is not to be construed as overruling a decision of the issuer or the board. Consequently, it is unclear whether a company is expected to abide by the results of the frequency vote or to simply conduct the vote to gauge the popularity of its decision as to how often it has scheduled the say-on-pay vote.

The SEC addresses both of these questions in its proposed rules.[25] With respect to the required form of the frequency vote, the Proposed Rules provide that shareholders must be given four choices: whether the say-on-pay vote should be held every one, two, or three years, or to abstain from voting on the matter.[26] In selecting this approach, the SEC rejected the alternative formulations described above. In addition, while the Commission acknowledged that companies would likely include the recommendation of their board of directors as to how shareholders should vote on the frequency vote, a company must make clear that shareholders are not voting to approve or disapprove the board's recommendation.[27]

[23] Exchange Act Rule 14a-4(b)(1).

[24] For example, under Delaware Corporation Law Section 216, it appears that a majority vote of the shares present and entitled to vote is required for all matters other than the election of directors (unless provided otherwise in the issuer's charter or by-laws). Thus, for some issuers, a plurality decision on the frequency vote may not be effective.

[25] In addition, for the same reasons set forth above with respect to the say-on-pay vote, the SEC is proposing to amend Exchange Act Rule 14a-6 to provide that the frequency vote also does not trigger the requirement to file a preliminary proxy statement. Proposed Exchange Act Rule 14a-6(a)(8).

[26] Proposed Exchange Act Rule 14a-4(b)(3).

[27] Proposing Release at Section II.B.3. In addition, because the frequency vote is merely advisory, the SEC did not prescribe a standard for determining which frequency has been "adopted" by shareholders. *Id.* at footnote 62.

Interestingly, the SEC is also proposing an amendment to its shareholder proposal rules to clarify the status of shareholder proposals that seek a shareholder advisory vote on executive compensation or that relate to the frequency of such votes. In the Commission's view, a company's response to a say-on-pay vote and related frequency vote may be viewed as having "substantially implemented" a subsequent shareholder proposal that seeks a shareholder advisory vote on the same matters, one of the enumerated substantive bases for excluding such a proposal. Consequently, the SEC intends to add a note to the exclusion for shareholder proposals that have already been substantially implemented to permit the exclusion of a proposal that would provide for a say-on-pay vote or seek future say-on-pay votes, or that related to a frequency vote, provided that the company has adopted a policy on the frequency of say-on-pay votes that is consistent with the plurality of votes cast in the most recent frequency vote.[28] Consequently, as long as a company is conducting its say-on-pay votes at a frequency that is consistent with its most recent frequency vote (and holding a frequency vote at least once every six years as required by Section 14A(a)(2)), it may exclude from its proxy materials any shareholder proposal relating to say-on-pay votes or frequency votes.

With respect to the effect of the frequency vote, the SEC confirms that the vote is not binding on a company or its board of directors and, therefore, does not preclude a company from conducting the required say-on-pay vote on a frequency which differs from the preference of a plurality of its shareholders as reflected in the most recent frequency vote.[29] The Commission is proposing to require companies, however, to publicly disclose their action as a result of the frequency vote.[30] In other words, a company will have to disclose whether it intends to follow the results of its most recent frequency vote or intends to conduct its say-on-pay votes on a different schedule.

[28] Proposed Note to Exchange Act Rule 14a-8(i)(10).

[29] Proposing Release at Section II.B.6.

[30] Proposed amendment to Item 9B of Form 10-K and Proposed Item 5(c) of Part II of Form 10-Q. As proposed, a company would be required to disclose, in the quarterly report on Form 10-Q covering the period during which the frequency vote occurs, or in the annual report on Form 10-K if the frequency vote occurs during the company's fourth fiscal quarter, its decision as to how frequently it will conduct say-on-pay votes in light of the frequency vote.

As with the say-on-pay vote, under the Proposed Rules, companies would be required to disclose in their proxy statement that they are providing a separate shareholder advisory vote on the frequency of the say-on-pay vote and to briefly explain the general effect of this vote, such as whether the vote is non-binding.[31]

*Action Items*

Although many investor groups have indicated their preference for an annual say-on-pay vote, most companies are likely to be carefully evaluating which schedule they will recommend to their shareholders in connection with the initial frequency vote. This decision will likely vary from company to company based on its investor relations history, corporate governance philosophy, and possible future executive compensation actions.

Companies should consider the following factors in making their recommendation:

- whether their executive compensation program contains one or more "problematic pay practices" or there is a pay-for-performance disconnect as determined by the major proxy advisory firms;
- whether their compensation committee members have received a high level of "withhold" or "against" votes in the past three years;
- whether they are planning to adopt new change-in-control arrangements for their executive officers (or materially modify existing arrangements) in the next three years;
- whether they are planning to adopt a new equity compensation plan or seek an increase to the share reserve of an existing plan in the next three years;
- whether their peers or other companies in their industry sector are holding their say-on-pay votes annually, biennially, or triennially;
- the policy position of their major shareholders on the frequency vote; and
- the likely impact of Section 957 of the Dodd-Frank Act (which prohibits broker voting of uninstructed shares on executive compensation matters) on their say-on-pay vote.[32]

These factors will play out differently for each company. Consequently, in making a specific recommendation to shareholders in 2011, it will be important to the company to explain the rationale for the vote frequency that it is advocating.

### *Advisory Vote on "Golden-Parachute" Compensation*

Finally, Section 14A addresses the use of "golden parachutes" or similar compensation arrangements in connection with a merger, consolidation, or other extraordinary corporate transaction. Specifically, Section 14A(b)(1) of the Exchange Act imposes a new mandatory disclosure requirement for all proxy or consent solicitation materials pursuant to which shareholders are being asked to approve a merger or other extraordinary corporate transaction. Under this requirement, any person making a proxy or consent solicitation seeking shareholder approval of an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all of the assets of an issuer must disclose in a clear and simple form in accordance with rules to be promulgated by the SEC:

- any agreements or understandings that such person has with any named executive officer of the issuer (or that it has with the named executive officers of the acquiring issuer) concerning any type of compensation (whether present, deferred, or contingent) that is based on or otherwise relates to the merger or other extraordinary corporate transaction; and
- the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer.[33]

[31] Proposed Item 24 to Schedule 14A.

[32] In the Proposing Release, the SEC confirms that Section 957, and the related rule changes of the national securities exchanges, apply to the shareholder advisory vote on the frequency of the shareholder vote on executive compensation. Proposing Release at Section II.C.2.

[33] In addition, similar disclosure would be required by an acquiring issuer of any agreements or understandings that it has with its named executive officers and that it has with the named executive officers of the target company in transactions in which the acquiring issuer is seeking shareholder approval of a

In addition, Section 14A(b)(2) of the Exchange Act requires that these disclosed agreements or understandings with the issuer's named executive must be approved by shareholders pursuant to a separate non-binding vote at the meeting where shareholders are asked to approve the merger or other extraordinary corporate transaction that would trigger the payment of the compensation, unless such agreements or understandings have previously been subject to the vote required by Section 14A(a)(1) (the "say-on-golden-parachutes vote").[34]

As with the other advisory votes set forth in Section 14A, the say-on-golden-parachutes vote is non-binding on a company and its board of directors, and specifically may not be construed as overruling a decision by the company or its board of directors, creating or implying any change in or additional fiduciary duty for the company or the board, or restricting or limiting the ability of shareholders to make proposals for inclusion in proxy materials relating to executive compensation.[35]

*Proposed Rules*

Initially, it is important to note that the disclosure requirements of Section 14A(b)(1) are not dependent on the say-on-golden-parachutes vote itself. In other words, although the requirement for a say-on-golden-parachutes vote does not arise where an agreement or understanding has been previously subject to a say-on-pay vote, the disclosure requirement applies to all change-in-control-related compensation arrangements and understandings, regardless of whether (or when) they have been subject to a shareholder advisory vote.

To satisfy this disclosure requirement, the SEC has proposed new narrative and tabular disclosure of named executive officers' golden-parachute arrangements.[36]

To reflect the realities of many merger and other extraordinary corporate transactions, this disclosure is intended to cover any golden-parachute arrangements among the target and acquiring companies and the named executive officers of each.

The centerpiece of the proposed disclosure is a new golden-parachute compensation table that would require the presentation of quantitative disclosure of the individual elements of compensation that a named executive officer would receive that are based on or otherwise relate to the merger or other extraordinary corporate transaction, and the total for each such officer. The specific elements of compensation that would be separately quantified and included in the total would be: (i) any cash severance payments (such as base salary, bonus, and *pro rata* non-equity incentive plan compensation payments); (ii) the dollar value of accelerated stock awards; (iii) in-the-money stock options for which vesting would be accelerated; (iv) payments in cancellation of stock and option awards; (v) pension and non-qualified deferred compensation benefit enhancements; (vi) perquisites and other personal benefits including health and welfare benefits; and (vii) tax reimbursements.[37] In addition, an "other" column would be included in the table for any additional elements of compensation not specifically includable in any of the other columns.[38]

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*footnote continued from previous page…*

merger or other transaction. Proposed Items 5(a)(5) and 5(b)(3) of Schedule 14A.

[34] *See also* Proposed Exchange Act Rule 14a-21(c), which would specify that the say-on-golden-parachutes vote is required in proxy statements for meetings at which shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all of a company's assets.

[35] Exchange Act §14A(c).

[36] Proposed Item 402(t) of Regulation S-K. For this purpose, the named executive officers subject to disclosure would include a company's principal executive officer, principal financial officer, and the three most highly compensated executive

*footnote continued from previous column…*

officers (other than the PEO and PFO) who were serving as executive officers at the end of the last completed fiscal year (Items 402(a)(3)(i), (ii), and (iii)). In the case of a smaller reporting company, the named executive officers subject to disclosure would include the company's principal executive officer and the two most highly compensated executive officers (other than the PEO) who were serving as executive officers at the end of the last completed fiscal year (Items 402(m)(2)(i) and (ii)). Disclosure would not be required with respect to individuals who would have been among the most highly compensated executive officers but for the fact that they were not serving as executive officers at the end of the last completed fiscal year. Proposing Release at footnote 88.

[37] The quantification of dollar amounts based on a company's stock price would be required to be based on the closing market price per share as of the latest practicable date. Instruction 1 to Proposed Item 402(t) of Regulation S-K.

[38] Interestingly, companies also would be required to identify, by means of separate footnotes, amounts attributable to "single-trigger" arrangements (that is, arrangements that do not require an executive's employment to be terminated without cause or that the executive resign with good reason within a specified time after a change-in-control of a company to trigger payment)

While the SEC considered making its current disclosure requirements for post-employment compensation in annual meeting proxy statements applicable to merger proxy statements, ultimately it concluded that certain compensation elements required by Section 14A(b)(1) were not covered by this existing disclosure.[39]

The amounts to be quantified in the table would be based on the relevant agreement or understanding, whether written or unwritten, between each named executive officer and the acquiring company or target company, concerning any type of compensation, whether present, deferred, or contingent, that is based on or otherwise relates to a merger or other extraordinary corporate transaction. The disclosable amounts would be limited, however, only to compensation that is based on or otherwise relates to the transaction. In other words, the table would not include so-called "walk-away" numbers (that is, amounts accumulated under retirement plans or in non-qualified deferred compensation accounts or previously vested equity awards).[40]

With respect to the proposed narrative disclosure, companies would be required to describe any material conditions or obligations applicable to the receipt of payments, including non-compete, non-solicitation, non-disparagement, or confidentiality agreements, their duration, and provisions regarding waiver or breach.[41] In addition, companies would be required to provide a specific description of the circumstances that would trigger payment, whether the payments would or could be lump sum or annual, their duration, by whom the payments would be provided, and any material factors regarding each agreement.[42]

Compared to the disclosure requirement, the say-on-golden-parachutes vote itself is straightforward. The SEC is not proposing that companies use any specific language or form of resolution for the vote. And as with the say-on-pay vote, this merger-related vote is non-binding and will not compel companies or their boards of directors to unwind or cancel these compensation arrangements. In addition, the presence of this vote will not preclude shareholders from continuing to submit proposals concerning golden-parachute arrangements to the company.[43]

It appears that this vote is aimed at discouraging companies from installing overly generous golden-parachute arrangements on the eve of a merger or other extraordinary corporate transaction. This vote will allow shareholders to at least register their displeasure with this maneuver, even though it won't impact the disposition of the arrangements.

It is expected that the say-on-golden-parachutes vote will place a greater premium on companies having their golden-parachute arrangements in place well before a proposed transaction and, presumably, subject to the general say-on-pay vote to take advantage of the exception to the say-on-golden-parachutes vote

*footnote continued from previous page…*

and amounts attributable to "double-trigger" arrangements (that is, arrangements that require such a termination or resignation after a change-in-control to trigger payment). Instruction 5 to Proposed Item 402(t) of Regulation S-K.

[39] For example, the current disclosure requirements for post-employment compensation in annual proxy statements do not require disclosure about arrangements that do not discriminate in scope, terms, or operation in favor of executive officers and that are available generally to all salaried employees. These requirements also permit the exclusion of *de minimis* perquisites and other personal benefits (that is, with a value of less than $10,000). Finally, the Commission has determined that meeting the statute's dictate that the information be presented in a "clear and simple form" is most appropriately satisfied by tabular disclosure, which is not required by the current disclosure rules.

[40] Nor would disclosure or quantification be required with respect to *bona fide* post-transaction employment agreements to be entered into in connection with the merger or other extraordinary corporate transaction.

[41] Proposed Item 402(t)(3) of Regulation S-K.

[42] *Id.*

[43] Note that, as proposed by the SEC, the disclosure requirements of Proposed Item 402(t) of Regulation S-K are slightly broader than the say-on-golden-parachutes vote required by Section 14A(b)(2). To ensure disclosure of the full scope of the golden-parachute compensation arrangements applicable to a merger or other extraordinary corporate transaction, the proposed rules require disclosure of the arrangements between a target company and any of its named executive officers and any named executive officers of the acquiring company, as well as the arrangements between an acquiring company and any of its named executive officers and any named executive officers of the target company. When a target company seeks shareholder approval of a merger or other extraordinary corporate transaction, however, the golden-parachute compensation arrangements between the acquiring company and the named executive officers of the target company are beyond the scope of the required vote. *See* Instruction 7 to Proposed Item 402(t)(2) of Regulation S-K for the special disclosure requirements in this situation.

requirement. This may be more difficult where the company's shareholders have approved the say-on-pay vote to take place every two or three years.[44]

Nonetheless, to simplify the matters upon which shareholders may be asked to vote in the event of a merger or other extraordinary corporate transaction, companies may seek to take advantage of this exception, particularly since, as the SEC confirms in its Proposing Release, Section 14A(b)(2) requires only that the golden-parachute compensation arrangements have been subject to a prior say-on-pay vote and need not have been approved by shareholders. In this case, shareholder attention to the descriptions of severance and change-in-control arrangements in a company's annual meeting proxy materials will be critical. The SEC is proposing that a company seeking to satisfy the exception to the say-on-golden-parachutes vote requirement must include the disclosure required by Proposed Item 402(t) of Regulation S-K, including the disclosure table described above, in its annual meeting proxy statement soliciting the say-on-pay vote.[45] As contemplated, this disclosure would satisfy the current disclosure requirement in annual meeting proxy statements with respect to the change-in-control arrangements of the company's named executive officers. The company would, however, still be obligated to include in the annual meeting proxy statement the disclosure required by the executive compensation disclosure rules about payments that may be made to named executive officers upon termination of employment.

Finally, as the SEC explains in its Proposing Release, once a golden-parachute compensation arrangement has satisfied the conditions of the exception, it is not subject to a say-on-golden-parachutes vote only to the extent that it is still in effect and its terms have not subsequently been modified. New golden-parachute compensation arrangements and any revisions to previously voted-on golden-parachute arrangements would be subject to a separate shareholder advisory vote as required by Section 14A(b)(2).[46]

*Action Items*

While the need for conducting a say-on-golden-parachutes vote will be situational, there are some items that a company should consider when preparing for the initial say-on-pay vote that may have an impact on this vote:

- make sure that all of its golden-parachute arrangements have been identified and described in its proxy materials;
- consider enhancing the disclosure of existing arrangements in its proxy materials, including a clear explanation of the rationale for each arrangement, so that there is no question that they are covered by the exception to the say-on-golden-parachutes vote; and
- highlight the portion of its post-employment compensation disclosure that relates to golden-parachute arrangements, including the inclusion of the golden-parachute compensation table.

*Effective Date*

Each of the shareholder advisory votes on executive compensation is effective for the first relevant meeting of shareholders occurring on or after January 21, 2011.[47] Consequently, in 2011, companies holding an annual meeting of shareholders will be required to conduct both a say-on-pay vote and a frequency vote.

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[44] If a company has approved new golden-parachute arrangements in an "off" year (that is, a year in which no say-on-pay vote is scheduled), it appears that it could hold a special say-on-pay vote to take advantage of the exception contained in Section 14A(b)(2).

[45] The amounts to be disclosed in the golden-parachute compensation table would be calculated based on the closing market price per share of the company's securities on the last business day of the company's last completed fiscal year, consistent with the quantification standards used in Item 402(j) of Regulation S-K. Instruction 2 to Proposed Item 402(t)(2) of Regulation S-K.

[46] In this situation, the SEC is proposing that a company would provide two separate golden-parachute compensation tables – one table would disclose all golden-parachute compensation, including both arrangements and amounts previously disclosed and subject to a say-on-pay vote, and the new arrangements and revised terms; the other table would disclose only the new arrangements and revised terms subject to the say-on-golden-parachutes vote. Instruction 6 to Proposed Item 402(t)(2) of Regulation S-K.

[47] Notwithstanding the statutory language, the SEC has indicated that, because the statute requires the disclosure prescribed by Section 14A(b)(1) to be made "in accordance with regulations to be promulgated by the Commission," the golden-parachutes vote and related disclosure will not be required for merger proxy statements relating to a meeting of shareholders until the final rules are adopted. Proposing Release at Section I.

Unfortunately, the SEC's schedule for adopting final rules with respect to Section 14A is likely to present problems for issuers who schedule their annual meeting of shareholders on or shortly after January 21, 2011, the effective date of Section 14A. Any proxy materials, whether in preliminary or definitive form for such meetings, even if filed prior to January 21, 2011, must include the separate resolutions for the say-on-pay vote and the frequency vote without regard to whether the Commission has adopted rules to implement Section 14A by that time.

Given the issues highlighted above, the SEC, to facilitate compliance with Section 14A(a), addresses two key transition issues in the Proposing Release. First, until the Commission takes final action to implement Section 14A, it will not object if companies do not file preliminary proxy statements if the only matters that would require a preliminary filing are the say-on-pay vote and the frequency vote.[48]

In addition, until the Commission takes final action to implement Section 14A, it will not object if the form of proxy for a frequency vote provides means whereby a shareholder is afforded an opportunity to specify by boxes a choice between one, two, or three years, or to abstain.[49] Further, where a proxy service provider is unable to reprogram its system to enable shareholders to vote among the four choices in time for the frequency vote, the SEC will not object if the form of proxy for a frequency vote provides means whereby the shareholder is afforded an opportunity to specify by boxes a choice among one, two, or three years, and proxies are not voted in the event that the shareholder does not select a choice among one, two, or three years.[50]

## SECTION 952 – COMPENSATION COMMITTEE INDEPENDENCE

Section 952 of the Dodd-Frank Act added new Section 10C to the Exchange Act which, generally, requires the SEC, by rule, to direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that does not require that:

- the members of its compensation committee meet enhanced independence standards; and

[48] Proposing Release at Section II.F.

[49] *Id.*

[50] *Id.*

- the compensation committee select compensation consultants, legal counsel, or other advisers (collectively "advisers") after taking into consideration independence standards established by the SEC.[51]

In addition, listed issuers are required to disclose in the proxy materials for an annual meeting of shareholders 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.[52]

### *Independence of Compensation Committee Members*

Section 10C(a) of the Exchange Act requires the SEC, by rule, to direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that does not require each member of the compensation committee of the listed issuer to be a member of the board of directors and "independent."[53] For purposes of determining an individual's independence, these SEC's rules are to require the national securities exchanges and national securities associations to consider relevant factors, including (but apparently not limited to):

[51] Dodd-Frank Act §952(a); Exchange Act §§10C(a) and (b).

[52] Exchange Act §10C(c)(2).

[53] This prohibition does not apply to a controlled company, limited partnership, company in bankruptcy proceedings, open-ended management investment company that is registered under the Investment Company Act, or a foreign private issuer that provides annual disclosure to shareholders of the reasons that the foreign private issuer does not have an independent compensation committee. Exchange Act §10C(a)(1). For this purpose, a "controlled company" is an issuer that is listed on a national securities exchange or by a national securities association and that holds an election for the board of directors of the issuer in which more than 50% of the voting power is held by an individual, a group, or another issuer. Exchange Act §10C(g)(2). In addition, the SEC's rules are to give the national securities exchanges and national securities associations the authority to exempt certain categories of issuers, including smaller reporting companies, from this requirement. Exchange Act §10C(f)(3). The SEC's rules are also to provide for appropriate procedures for an issuer to have a reasonable opportunity to cure any defects that would be the basis for a de-listing for failure to satisfy the requirements of the prohibition. Exchange Act §10C(f)(2).

- the source of compensation of a member of the board of directors, including any consulting, advisory, or other compensatory fee paid by the issuer to such individual; and
- whether a member of the board of directors is affiliated with the listed issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.[54]

*Open Issues*

While the factor involving the source of compensation of a compensation committee member is straightforward and doesn't present any obvious interpretive issues, the factor concerning a committee member's possible status as an affiliate of the company or a related entity may be problematic for many companies. Typically, these are companies where a venture capital or other investment firm holds a significant equity stake in the company and also has one of its partners or members serving as a director and member of the compensation committee of the board of directors. Under SEC rules, these facts may result in "affiliate" status for the compensation committee member.[55] While the provision's description of this factor does not dictate that a member of the compensation committee who is also an affiliate cannot be independent for purposes of Section 10C(a),[56] ultimately, it will be up to the SEC to decide how this factor is to be interpreted and applied.

*Action Items*

While a comprehensive review of the independence of the members of a compensation committee will have to wait until the SEC and the national stock exchanges have completed their rulemaking, companies may wish to reexamine the status of their current compensation committee members now to see whether a potential issue may be pending. Where it expects that it may not have enough independent compensation committee members, a company should consider increasing the size of its board of directors and/or recruiting new members.

***Independence of Compensation Consultants and Other Compensation Committee Advisers***

Section 10C(b) of the Exchange Act requires the SEC, by rule, to direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that does not agree that the compensation committee of the listed issuer may only select an adviser to the compensation committee after taking into consideration factors that affect the independence of such adviser as identified by the SEC.[57]

For this purpose, these factors, which are to be competitively neutral among categories of advisers and preserve the ability of compensation committees to retain the services of members of any such category, must include:

- the provision of other services to the issuer by the person that employs the adviser;
- the amount of fees received from the issuer by the person that employs the adviser as a percentage of that person's total revenue;
- the policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the adviser with a member of the compensation committee; and
- any stock of the issuer owned by the adviser.[58]

It is important to note that this provision does not require compensation committees to engage only independent advisers, but simply to determine whether any such adviser is, in fact, independent under the

[54] Exchange Act §§10C(a)(3) (A) and (B).

[55] As defined in Exchange Act Rule 12b-2, an "affiliate" of, or a person "affiliated" with, a specified person, is a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

[56] This conclusion is supported by the difference between the language of Exchange Act §10C(a)(3)(B) and the language of Exchange Act §10A(m)(3)(B) with respect to the independence of members of the board of directors of a listed issuer who serves on the audit committee of the board of directors ("In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee . . . . be an affiliated person of the issuer or any subsidiary thereof).

[57] Exchange Act §§10C(b)(1) and (f). This prohibition does not apply to controlled or exempt companies, and issuers are to have a reasonable opportunity to cure any defects. *Supra* note 53.

[58] Exchange Act §§10C(b)(2)(A) – (E).

standards established by the SEC. Accordingly, while, as a practical matter, most compensation committees are likely to only use independent advisers, there will be situations where other considerations may outweigh these criteria in the selection process.

Section 10C also delineates the ability of the compensation committees of listed issuers to retain advisers, expressly stating that the compensation committee, in its capacity as a committee of the board of directors, may, in its sole discretion, retain and obtain the input of advisers.[59] It also expressly states that the compensation committee is directly responsible for the appointment and compensation of the advisers[60] and the oversight of their work.[61] Interestingly, the provision also makes clear that the compensation committee is not required to follow the advice or recommendations of its advisers,[62] and the input of advisers does not affect the ability or obligation of the committee to exercise its own judgment in discharging its responsibilities.[63]

Section 10C(c)(2) provides that the proxy materials for an annual meeting of the shareholders of a listed issuer must disclose whether the compensation committee retained or obtained the advice of a compensation consultant, whether the consultant's work has raised any conflict of interest, and, if so, the nature of the conflict and how it is being addressed.

*Open Issues*

The primary thrust of this provision is process-oriented; clearly establishing the ability of compensation committees to select expert advisers to provide advice and support, and introducing an evaluation process that must be conducted before that selection is made. The most problematic aspect of this new framework is the factors that a compensation committee must consider to ascertain the objectivity and impartiality of a prospective adviser.

As was true with respect to determining director independence, the SEC will face numerous challenges in identifying and delineating the various factors required to implement the key component of this provision. And each affected constituency will be watching to ensure that it is not treated any less favorably than its counterparts. For example, consulting firms that specialize in executive compensation are likely to be very interested in the factor that covers fees as a percentage of total revenue (an issue that was aggressively pursued by the full-service human resources firms during 2009 in their attempt to forestall the SEC's disclosure requirements about the provision of non-compensation-related services) and its potential implications for independence. Similarly, law firms that provide legal services to Company A whose chief executive officer serves on the compensation committee of Company B will be interested in ensuring that an engagement with the compensation committee of Company B will not threaten their pre-existing client relationship with Company A.

Since the factors identified in the provision are not intended to be exhaustive, there is also a question as to what additional factors, if any, the SEC will deem relevant to the independence assessment. Given the competing views of companies, investors, and the professions that support them, the overriding challenge for the SEC will be to craft factors that are workable while, at the same time, maintaining competitive neutrality among large and small consulting and law firms.

Finally, the SEC should seek to integrate the new disclosure requirements of Section 10C with its existing compensation consultant disclosure requirements,[64] including its recently adopted rules on the role and services of compensation consultants. On their face, they don't appear to conflict. The recently adopted rules require disclosure related to the role and services provided by a compensation consultant, as well as disclosure of any additional non-executive compensation-related services provided by the consultant. They also require disclosure of the aggregate fees paid both for the compensation consulting and for the additional services, if the fees for the additional services were in excess of $120,000 during the past fiscal year.[65]

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[59] Exchange Act §§10C(c)(1)(A) and (d)(1).

[60] Exchange Act §§10C(c)(1)(B) and (d)(2).

[61] Each issuer is to provide for appropriate funding, as determined by the compensation committee, in its capacity as a committee of the board of directors, for reasonable compensation of advisers to the committee. Exchange Act §10C(e).

[62] Exchange Act §§10C(c)(1)(c)(i) and (d)(3)(A).

[63] Exchange Act §§10C(c)(1)(C)(ii) and (d)(3)(B).

[64] Item 407(e)(3) of Regulation S-K. It should be noted that the disclosure requirements of Exchange Act §10C apply only to compensation consultants; they do not extend to legal counsel or other advisers.

[65] *Id.*

*Action Items*

Once again, technical compliance with Section 10C(b) will depend on the rules developed by the SEC and the national stock exchanges. In the interim, companies should have their compensation committees evaluate their current adviser relationships (primarily their compensation consultant relationships) to identify any potential discussion points under the factors identified in the provision. Companies should also consider how they will address the proxy disclosure requirement under Section 10C(c)(2); in particular, whether, in addition to the required items, how they will discuss the assessment of the independence of the committee's advisers, including the analysis of each enumerated factor.

*Effective Date*

Section 10C(f) requires the SEC to direct the national securities exchanges and national securities associations to amend their listing standards to comply with the requirements of Section 952 of the Dodd-Frank Act by July 16, 2011. In September, the SEC indicated that it intends to propose rules with respect to this provision during the October-December 2010 timeframe and adopt such rules during the April-July 2011 timeframe.[66] Since this rule is to be implemented as a listing standard, it will also require some rulemaking by the national securities exchanges and national securities associations.[67] Consequently, this provision will not be effective until late 2011, at the earliest, and, in all likelihood, will not apply until the 2012 proxy season.

In the case of the compensation committee disclosure requirement, Section 10C(c)(2) stipulates that the required information is to be included in the proxy materials for annual meetings of shareholders occurring on or after July 21, 2011.

## SECTION 953 – EXECUTIVE COMPENSATION DISCLOSURES

There are two explicit disclosure provisions in the Dodd-Frank Act: calling for enhanced disclosure of the relationship between executive compensation and corporate financial performance, and between senior executive compensation and median employee compensation.

***Pay Versus Performance Disclosure***

Section 953(a) of the Dodd-Frank Act added new Section 14(i) to the Exchange Act which, generally, requires the SEC to adopt rules mandating disclosure by issuers in their proxy materials for an annual meeting of shareholders of a clear description of the compensation required to be disclosed under Item 402 of Regulation S-K. This includes information showing the relationship between the compensation actually paid to the executive officers and corporate financial performance. This disclosure may be presented graphically or in narrative form.

*Open Issues*

Although simply stated, the provision presents a number of difficult interpretive matters. First, Section 14(i) requires companies to provide a "clear description" of any compensation required to be disclosed by the company under Item 402 of Regulation S-K. It isn't clear whether this directive is intended to simply reaffirm the primacy of the SEC's current executive compensation disclosure rules, particularly as they relate to the Compensation Discussion and Analysis required by Item 402(b), or to require a revaluation and possible enhancement of those requirements as they relate to the relationship between a company's executive compensation actions and corporate financial performance.

To the extent that the provision contemplates a new disclosure item – the graphic or narrative comparison of executive compensation and corporate financial performance, it bases this presentation on the "executive compensation actually paid" to a company's senior executive officers. This concept of amounts "actually paid" appears to differ from the "total compensation" that is currently required to be disclosed by companies in the Summary Compensation Table.[68] Thus, it will be necessary for the SEC to explain how companies are to identify and value amounts that are actually paid in a given fiscal year, in contrast to amounts paid, earned, and awarded, the current basis for determining total compensation.

It also will be necessary for the SEC to provide guidance on the approach or approaches that companies may use to present their financial performance. Under Section 14(i), the financial performance of a company is to be measured taking into account any change in value of the shares of stock and dividends of the company and

[66] *Supra* note 3.

[67] Exchange Act §§10C(a) and (f).

[68] Item 402(c)(2)(x) of Regulation S-K.

any distributions. While total shareholder return ("TSR") is one common measure that serves this purpose, and which is already used by companies to prepare the Performance Graph that must be included in their glossy annual reports to shareholders,[69] it is not clear whether this is the only measure which companies can use to satisfy this requirement.

Finally, it's not clear over what period the relationship between pay and performance is to be measured and discussed. While it would appear to contemplate a period longer than one year, Section 14(i) is actually silent on this point. It will be up to the SEC to specify the appropriate period to be covered or to confer upon companies the ability to make this decision for themselves.

*Action Items*

While compliance with Section 14(i) won't be practical until the SEC provides guidance on the operation of the provision, companies should review their past disclosures of their incentive compensation arrangements and consider providing greater disclosure about the relationship of their compensation policies and practices to their financial performance. In the new say-on-pay environment, this will be a topic that may warrant discussion in the executive summary to the Compensation Discussion and Analysis.

*Effective Date*

While the SEC is directed to implement this disclosure requirement by rule, it was not given a deadline for doing so. In September, the SEC indicated that it intends to propose rules with respect to this provision during the April-July 2011 timeframe.[70]

***Pay Ratio Disclosure***

Section 953(b) of the Dodd-Frank Act requires the SEC to amend Item 402 of Regulation S-K to mandate disclosure in an issuer's Securities Act and Exchange Act filings of:

- the median annual total compensation of all employees (except the chief executive officer);
- the annual total compensation of the chief executive officer; and
- the ratio of the median employee annual total compensation to the chief executive officer's annual total compensation.[71]

For this purpose, "total compensation" is to be based on Item 402 of Regulation S-K as in effect on July 20, 2010, the day before the day the Dodd-Frank Act was signed into law.[72]

The concept of evaluating executive compensation on the basis of internal pay equity is not new. For some time now, it's actually been a fairly common way of illustrating the growing gap between what companies pay their chief executive officers and what they pay their average workers. It's even been the basis for a congressional proposal to try to limit executive pay.[73]

Intended to highlight the growing disparity between executive and rank-and-file pay, the meaningfulness of this comparison has been questioned. Moreover, as discussed below, the required disclosure presents a number of compliance obstacles that will have to be addressed before the provision is implemented.

*Open Issues*

Of the various executive compensation provisions in the Dodd-Frank Act, this one has drawn the most attention – and criticism – because of its mandate that companies identify the median annual total compensation of their workforce for purposes of comparing that compensation level to that of their chief executive officer. While smaller companies may be able to come up with this figure without too much difficulty, larger companies, particularly global companies, expect compliance to be daunting, if not impossible. For these companies, compliance is problematic for two reasons: the absence of an integrated global compensation database from which to access the necessary data and the

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[69] Item 201(e) of Regulation S-K.

[70] *Supra* note 3.

[71] This disclosure is to be included in any filing described in Item 10(a) of Regulation S-K, including registration statements under the Securities Act, registration statements under Exchange Act §12, annual or other reports under Exchange Act §§13 and 15(d), going-private transaction statements under Exchange Act §13, tender offer statements under Exchange Act §§13 and 14, annual reports to security holders and proxy and information statements under Exchange Act §14, and any other documents required to be filed under the Exchange Act.

[72] Dodd-Frank Act §953(b).

[73] *See* H.R. 1594, the "Income Equity Act of 2009," which was introduced in the 111th Congress by Representative Barbara Lee (D-CA).

complexity associated with determining the annual total compensation of their employees.

Contrary to common perceptions, most companies do not maintain data about the compensation of their employees in a single unified database. In addition, even where this information is readily available, in most instances it does not contain the relevant data on all of the various pay components, such as accrued retirement benefits and non-cash items, that are part of the SEC's existing methodology for determining total compensation. Consequently, if the provision's edict that median employee annual total compensation be derived from a company's world-wide work force, many companies will be compelled to expend considerable time and effort, as well as incur significant expense, to generate this number.

There are three significant technical problems with the provision:

- it requires the pay ratio disclosure in virtually all of an issuer's SEC filings, not just its proxy materials for its annual meeting of shareholders – the document that contains all of its other executive compensation information;

- it bases "total compensation" on the SEC's executive compensation disclosure rules as they existed on July 20, 2010; and

- it requires issuers to compare the median annual total compensation of all employees (excluding the CEO) to the annual total compensation of the CEO, rather than the more commonly understood reciprocal.

While it would be desirable for the SEC to address each of these issues, it may be difficult for the agency to do so. The SEC's ability to interpret congressional intent to reach a practical result on each of these items is constrained by the language of the statute itself. Consequently, it's probably going to take a technical correction to the provision to resolve these matters.

*Effective Date*

While the SEC is directed to implement this disclosure requirement by rule, it was not given a deadline for doing so. In September, the SEC indicated that it intends to propose rules with respect to this provision during the April-July 2011 timeframe.[74]

Given the obvious problems with this provision, it is likely that the SEC has chosen to defer action until Congress has had an opportunity to consider whether any technical corrections are warranted.

## SECTION 954 – RECOVERY OF ERRONEOUSLY AWARDED COMPENSATION

Section 954 of the Dodd-Frank Act added Section 10D to the Exchange Act concerning the recovery of erroneously awarded compensation (a so-called "clawback" policy). Generally, Section 10D requires the SEC, by rule, to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not have a policy that:

- discloses its policy on incentive-based compensation that is based on financial information required to be reported under the securities laws; and

- provides for compensation recovery:

  — in the event the issuer is required to restate its financial statements due to material non-compliance with any financial reporting requirement;

  — covers any current or former executive officer who received incentive-based compensation (including stock options) during the three-year period preceding the date when the issuer is required to prepare the restatement; and

  — recovers the amounts in excess of what would have been paid to the executive officer under the restatement.[75]

*Open Issues*

Once again, while the general objective of Section 10D is clear, there are several interpretive matters that will have to be addressed by the SEC before the provision can be implemented. First, Section 10D(b)(1) appears to establish a requirement that companies disclose their policy on incentive-based compensation that is based on financial information required to be reported under the securities laws. It is not clear whether this is intended to be an independent disclosure requirement or, instead, should be read in conjunction with the required description of a clawback policy.

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[74] *Supra* note 3.

[75] Exchange Act §10D(b).

With respect to the clawback policy itself, it is not clear what constitutes "incentive-based compensation" subject to recovery. While it is possible that this term is intended to be interpreted broadly, it is also possible that, consistent with the preceding disclosure requirement, it is limited to "incentive-based compensation that is based on financial information required to be reported under the securities laws."[76] Although this will encompass many of the common performance measures that are used in designing incentive compensation arrangements, it is not a comprehensive description, leaving open the possibility that some types of performance-based arrangements may not be subject to the required policy.

Similarly, questions exist as to how Section 10D is to apply to equity-based incentive compensation. While it is likely that the provision's express reference to "stock options" is intended to be illustrative rather than dispositive (otherwise a company could sidestep the policy by simply shifting its equity-based compensation to restricted stock, performance shares, and similar awards), it is less clear whether the policy covers equity awards that are subject solely to service-based, rather than performance-based, vesting conditions.

Additional issues are raised by the description of the event that would trigger application of the clawback policy. As stipulated in Section 10D(b)(2), recovery is required only upon a financial restatement resulting from material non-compliance with any financial reporting requirement under the securities laws. In this context, it is unclear what constitutes "material" non-compliance, as well as who must make this determination. Since the standards of materiality are typically based on the facts and circumstances of each particular situation, it is possible that, absent guidance, the conditions that would constitute such non-compliance with financial reporting requirements could vary dramatically from company to company.

The provision also indicates that compensation is to be recovered for a period of three years, measured from the date the issuer is "required to prepare the accounting restatement." It is unclear what event will signify when a company becomes obligated to prepare an accounting restatement for purposes of measuring the three-year recovery period. While it is likely that Congress intended this to be a date related to the period that the restatement is intended to cover (rather than the date upon which the decision to undertake the restatement is made or the date that the work on the restatement actually commences), the vagueness of this standard suggests that the SEC will be required to specify how it is to be applied in a variety of common situations (for example, where a decision is made in 2011 to restate the financial statements for the period from 2005-2007).

Finally, computation of the amount recoverable is a potentially challenging task. While recovery is limited to the difference between what the executive officer received, based on erroneous data, and what he or she otherwise would have received, based on the restated financial statements, in many situations this amount may not be readily apparent. For example, in the case of a performance-based stock option, it is not clear whether the amount recoverable should be determined based on the number of shares granted or the amount realized upon exercise and, in the case of the latter, whether the amount recoverable is to be based on the fair market value of the company's equity securities on the date of exercise, the date of sale (if subsequently sold), or the date of the financial restatement. Given the growing complexity of many incentive compensation plans and arrangements, which often feature, among other things, multi-year performance periods and award payouts, elective cash or equity payout features, post-performance period vesting requirements, and award deferral features, companies may struggle to figure out exactly what has to be returned.

It appears that Section 10D(b)(2) is intended to operate automatically without regard to whether the recovery of the erroneously awarded compensation is in the best interests of the company and its shareholders. Accordingly, even where the costs of recovery would outweigh the amount recoverable, it appears that recovery would be required. It is hoped that the SEC, in adopting rules to implement this provision, will establish a "reasonableness" test that will give companies some flexibility to forego recovery where the costs exceed the benefits to be obtained.[77]

[76] Exchange Act §10D(b)(1).

[77] In implementing Section 111(b)(3)(B) of EESA, which contains a compensation recovery provision applicable to TARP recipients, the Department of the Treasury applies a cost-benefit approach to recovery. Section 30.8-Q. 8 of Department of the Treasury TARP Standards for Compensation and Corporate Governance provides that a TARP recipient must exercise its clawback rights except to the extent it demonstrates that it would be unreasonable to do so, such as, for example, if the expense of enforcing the right would exceed the amount recovered.

*Action Items*

Unlike some of the other executive compensation provisions of the Dodd-Frank Act, Section 954 adds a requirement to an already crowded field. Section 304(a) of the Sarbanes-Oxley Act of 2002[78] provides for the recovery of compensation and realized profits from an issuer's chief executive officer and chief financial officer in the event of an accounting restatement due to the material non-compliance of the issuer, as a result of misconduct, with any financial reporting requirements under the securities laws. Similarly, the EESA,[79] as modified by the American Recovery and Reinvestment Act of 2009,[80] requires each TARP recipient to recover any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly compensated employees of the TARP recipient based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.[81] Thus, companies will be responding to this new requirement within the framework of their existing response to one or both of these provisions.[82]

Where a company does not already have a compensation recovery policy, it will need to adopt such a policy within the timeframe established by the SEC. Here, the primary question will be whether to simply adopt a policy that conforms to the requirements of Section 10D(b)(2), or to consider a more expansive policy.

Where a company already has a compensation recovery policy, it will need to compare its existing policy to the requirements of Section 10D(b)(2) and decide whether any modifications or enhancements are necessary or appropriate. To the extent that a company's existing policy differs materially from the requirements of Section 10D(b)(2), it should consider discussing the rationale or justification for maintaining two separate policies that may cover different triggering events and/or individuals.

In either situation, companies should consider enhancing their current disclosure of their compensation recovery policy, both in the Compensation Discussion and Analysis and in connection with the advisory vote on executive compensation – shareholders are likely to want to know how this policy stacks up against the mandated new standard.

*Effective Date*

While the SEC is directed to implement this disclosure requirement by rule, it was not given a deadline for doing so. In September, the SEC indicated that it intends to propose rules with respect to this provision during the April-July 2011 timeframe.[83] In addition, because this rule is to be implemented as a listing standard, it will require some rulemaking by the national securities exchanges and national securities associations.[84] Consequently, this provision will not be effective until late 2011, at the earliest, and, in all likelihood, will not apply until the 2012 proxy season.

## SECTION 955 – DISCLOSURE REGARDING EMPLOYEE AND DIRECTOR HEDGING

Section 955 of the Dodd-Frank Act added new Section 14(j) to the Exchange Act which, generally, requires the SEC to adopt rules mandating disclosure in the proxy materials for any annual meeting of shareholders as to whether any employee or member of the board of directors of an issuer, or designee of such persons, is permitted to purchase financial instruments, including 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.

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[78] Public Law 107-304 (July 30, 2002).

[79] Public Law 110-343 (October 3, 2008); 12 U.S.C. §5201 *et seq.*

[80] Public Law 111-5 (February 17, 2009).

[81] EESA, §111(b)(3)(B).

[82] Section 10D applies to a larger group of companies than Section 111(b)(3)(B) of EESA (which applies only to TARP recipients) and a smaller group of companies than Section 304 of the Sarbanes-Oxley Act (which applies to all public companies). In addition, Section 10D (which covers a company's "executive officers") is more expansive than Section 304 of the Sarbanes-Oxley Act, which only covers a company's chief executive officer and chief financial officer, and more restrictive than Section 111(b)(3)(B) of EESA, which applies to a TARP recipient's senior executive officers and its next 20 most highly compensated employees. Finally, the compensation recovery period of Section 10D is three years, which is longer than the period covered by Section 304 of the Sarbanes-Oxley Act (12 months), and (potentially) shorter than the period covered by Section 111(b)(3)(B) of EESA, which applies to any payment made during the period that a company is a TARP recipient.

[83] *Supra* note 3.

[84] Exchange Act §10D(a).

It is important to note that Section 14(j) does not require companies to have a hedging policy, but simply to disclose whether they have a policy that conforms to the description in the provision.[85] Nonetheless, while couched as a disclosure, rather than a substantive, requirement, this provision appears to be designed to promote the adoption of a comprehensive hedging policy by companies. In addition, even where a company already has a policy, it will now be measured against the standard established by Section14(j).

*Open Issues*

While this provision is largely self-explanatory, there are a few interpretive matters that the SEC is likely to address in its rules implementing the provision. First, it is not clear from the provision itself whether the required disclosure should be presented as part of a company's executive compensation disclosure or simply included within the company's proxy materials. While Item 402(b)(2) of Regulation S-K lists a registrant's policy regarding the hedging of the economic risk of ownership of its equity securities as a possible topic for discussion in the Compensation Discussion and Analysis, this disclosure is required only to the extent material to an understanding of the registrant's executive compensation program.[86] Thus, it is currently addressed by some companies, but not others, as part of their executive compensation disclosure. Given investor interest in this subject, which goes directly to the question of whether a compensation program reflects a "pay-for-performance" orientation, it is likely that the SEC will direct this disclosure to accompany the Compensation Discussion and Analysis and related compensation tables.

In addition, it is not clear from the provision whether the required disclosure may be satisfied by a simple statement that a company does or does not have a hedging policy that conforms to the description set forth in Section 14(j), or whether the company must describe how its policy varies from the Dodd-Frank standard.

*Action Items*

Where a company does not already have a hedging policy, it will need to decide whether, in light of the new disclosure requirement, it is still comfortable with this status. It is likely that many such companies will opt to establish a company-wide policy consistent with the disclosure requirements of Section 14(j) to avoid the potential negative implications that may arise from disclosing that this is not an area that the company monitors. Such policies will likely provide for one of the following alternatives:

- banning all hedging transactions;
- subjecting hedging transactions to a "pre-approval" process;
- restricting the type of hedging transactions that may be conducted; or
- continuing to permit hedging transactions without any restriction on their use.

Where a company already has a hedging policy, it will need to compare its existing policy to the disclosure requirements of Section 14(j) and decide whether any modifications or additions are necessary or appropriate. Further, to the extent that its hedging policy differs in one or more material respects from the Section 14(j) standards – a fact that will need to be disclosed – a company should consider developing an explanation for these differences to accompany the required disclosure. Inasmuch as there are a number of features of Section 14(j) which may go farther than many of the corporate hedging policies that are currently in place (for example, coverage of all employees rather than just executive officers and directors, as well as the type of financial instruments expressly covered), most companies are likely to be faced with this prospect.

*Effective Date*

While the SEC is directed to implement this disclosure requirement by rule, it was not given a deadline for doing so. In September, the SEC indicated that it intends to propose rules with respect to this provision during the April-July 2011 timeframe.[87] Consequently, this provision will not be effective until late 2011, at the earliest, and, in all likelihood, will not apply until the 2012 proxy season.

## SECTION 956 – ENHANCED COMPENSATION STRUCTURE REPORTING

Section 956(e)(2) of the Dodd-Frank Act requires a number of federal banking regulators to jointly prescribe regulations or guidelines requiring certain financial

[85] It is also important to note that Section 14(j) does not require disclosure of actual hedging transactions. In the case of executive officers and directors, however, such transactions may be disclosable under Exchange Act §16(a) (15 U.S.C. §78p(a)).

[86] Item 402(b)(2)(xiii) of Regulation S-K.

[87] *Supra* note 3.

institutions[88] with assets of $1 billion or more to disclose to their principal regulator the structures of their incentive-based compensation arrangements for their executive officers, employees, directors, and principal shareholders.[89] In addition, these regulators are required to jointly prescribe regulations or guidelines that prohibit any type of incentive-based payment arrangement that they determine encourages inappropriate risks by covered financial institutions by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or which could lead to material financial loss.[90]

While these new regulations or guidelines are aimed at the financial sector, given the heightened interest in compensation-related risk, particularly in the case of highly leveraged incentive compensation arrangements, it is likely that they will serve as a guide for companies in designing their executive compensation programs, as well as the risk management assessment of their compensation policies and practices.[91]

*Effective Date*

The appropriate federal regulators must complete their rulemaking under this provision by April 21, 2011.

## SECTION 957 – VOTING BY BROKERS

Section 957 of the Dodd-Frank Act amended Section 6(b) of the Exchange Act, which sets forth the requirements for registration of a national securities exchange, to prohibit any member that is not the beneficial owner of a security registered under Section 12 of the Exchange Act from granting a proxy to vote the security in connection with a shareholder vote with respect to the election of a member of the board of directors of an issuer, executive compensation, or any other significant matter, as determined by the SEC, unless the beneficial owner of the security has instructed the member to vote the proxy in accordance with the voting instructions of the beneficial owner.[92]

This provision both codifies the New York Stock Exchange's 2009 change to NYSE Rule 452 prohibiting exchange members from voting uninstructed shares in uncontested director elections,[93] and extends this prohibition to cover executive compensation matters, including the various advisory votes on executive compensation under Section 951 of the Dodd-Frank Act.[94] As it also applies to any shareholder vote involving "executive compensation," it appears that it could extend to numerous compensation-related matters, such as to satisfy the conditions of the "performance-based compensation" exception of Section 162(m) of the Internal Revenue Code[95] and the approval of severance agreements.

*Effective Date*

The amendment to Section 6(b) became effective on July 21, 2010. Since then, to maintain their Exchange Act registrations, the New York Stock Exchange[96] and the NASDAQ Stock Market[97] have amended their rules to add executive compensation to the list of matters upon which brokers are no longer permitted to vote uninstructed shares.

In September, the SEC indicated that it intends to propose rules addressing the "other significant matters" prong of the provision for which brokers will not be permitted to vote uninstructed shares during the April-July 2011 timeframe.[98]

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[88] The covered financial institutions include: a depository institution or depository institution holding company, as such terms are defined in Section 3 of the Federal Deposit Insurance Act, a broker-dealer registered under Exchange Act §15, a credit union as described in Section 19(b)(1)(A)(iv) of the Federal Reserve Act, an investment advisor, as such term is defined in Section 202(a)(11) of the Investment Advisers Act, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and any other financial institution that the appropriate federal regulators, jointly, by rule, determine should be treated as a covered financial institution for purposes of this provision.

[89] Dodd-Frank Act §956(a)(1).

[90] *Id*. §956(b). The compensation-related standards established by these federal regulators must be comparable to the standards established under Section 39 of the Federal Deposit Insurance Act for insured depository institutions and take into consideration the compensation standards described in Section 39(c) of the Federal Deposit Insurance Act. *Id.* §956(c).

[91] Item 402(s) of Regulation S-K.

[92] Exchange Act §§6(b)(10)(A) and (B).

[93] Exchange Act Rel. No. 60215 (July 1, 2009).

[94] This includes the say-on-pay vote, the frequency vote, and the say-on-golden-parachutes vote.

[95] 26 U.S.C. §162(m).

[96] Exchange Act Rel. No. 62874 (September 9, 2010).

[97] *Id*. 62992 (September 24, 2010).

[98] *Supra* note 3.

## CONCLUSION

The staged implementation of the executive compensation provisions of the Dodd-Frank Act ensures that this play's final act won't be written for at least two more years. While say-on-pay is likely to dominate the 2011 proxy season, the additional layer of regulation slated for 2012 will force companies – and investors – to adjust their executive compensation practices and analyses, respectively, once the full effect of the provisions takes hold. This transition will be further complicated as the other significant corporate governance changes and trends, including proxy access, majority voting for the election of directors, and proxy "plumbing" enhancements, make their presence felt. Thus, even though we can see how the compensation landscape is likely to take shape, undoubtedly it will contain at least a few surprises. ■