The Dodd-Frank Act Executive Compensation Provisions – What You Should be Doing Now

The recent adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which contains several significant new requirements affecting executive compensation programs, has focused the attention – and raised the anxiety levels – of public companies as we head into the fall. It is worth noting, however, that each of these new requirements has its own effective date (or no express effective date at all), meaning that they are likely to be implemented on a staggered basis over the next 18 months.

But that doesn't mean that companies shouldn't be preparing now for their eventual compliance with these new requirements. From the mandatory advisory vote on executive compensation (which becomes effective in January 2011) to the enhanced disclosure requirements about executive pay and corporate performance (which may not become operative until sometime next year), there are several considerations that companies – and board compensation committees – should begin focusing on in the months ahead.

To assist you in organizing your action plan for the rest of the year, we summarize below our recommendations for responding to the new Dodd-Frank Act requirements.

Advisory Vote on Executive Compensation ("Say on Pay")

What Does the Dodd-Frank Act Require?

The Dodd-Frank Act requires public companies to conduct a non-binding shareholder advisory vote on their executive compensation programs (as reflected in the executive compensation disclosure in their proxy statements) at least once every three years. This vote is non-binding on the company and its board of directors – specifically, the vote may not be construed as:

- Overruling a decision by the board of directors
- Creating or implying any change in or additional fiduciary duty for the board
- Limiting shareholders' right to make executive compensation proposals

When Do We Have to Comply?

This new requirement applies to any annual meeting of shareholders held after January 21, 2011. While subsequent votes will be held annually, biennially, or triennially, as determined by the company's shareholders, all companies will be required to conduct a "Say on Pay" vote in 2011.

What Should We Being Doing Now?

Until the SEC adopts rules addressing several technical questions related to the new requirement (for example, whether companies will need to file a preliminary proxy statement containing their "Say on Pay" resolution and what form this resolution must take), you should consider taking the following actions now:

- Address any lingering concerns about your executive compensation program (for example, have any features of your program been characterized as "poor pay practices" by investors or the major proxy advisory firms or have you received a "high risk" rating under Institutional Shareholder Services' Governance Risk Indicators ("GRId") tool? Alternatively, has your Board of Directors been "on the fence" about adopting new program features, such as stock ownership guidelines or an anti-hedging policy?)
- Review your current executive compensation disclosure to see whether it should be improved (for example, should you add an "executive summary" or "overview" to highlight key compensation actions

and decisions, or replace narrative disclosure with the crisp use of graphics?)

- Determine whether you are at risk for a "no" vote based on one or more of the following:
  - potential "red flags" arising from a comparison of your program against the executive compensation policies of your key shareholders and the major proxy advisory firms
  - a previous "against" or "withhold" vote recommendation issued by a major proxy advisory firm on your compensation committee members
  - a substantial "against" or "withhold" vote against one or more of your compensation committee members in 2010
- Analyze your shareholder base to determine whether the new Dodd-Frank Act prohibition on broker voting of uninstructed shares on executive compensation matters will have an impact on your vote

Shareholder Vote on Frequency of "Say on Pay" Vote

What Does the Dodd-Frank Act Require?

The Dodd-Frank Act requires public companies to conduct a separate shareholder vote on the frequency of the advisory vote on their executive compensation program ("Say on Pay") vote, with a choice of annually, every two years, or every three years.

When Do We Have to Comply?

This new requirement applies to any annual meeting of shareholders held after January 21, 2011. Thereafter, shareholders are to be given the opportunity to vote on the frequency of the "Say on Pay" vote not less frequently than once every six years.

What Should We Being Doing Now?

Like the "Say on Pay" vote itself, we expect that the SEC will shortly adopt rules outlining the form, content, and mechanics of this new requirement. Until then, you should consider which alternative your company will recommend to shareholders. While we expect many companies to opt for conducting the vote every three years, there are several factors that will influence your recommendation, including your executive compensation program profile (compared against ISS' policy guidelines), the likelihood that you will be submitting a new employee stock plan for shareholder proposal within the next five years, your policy on post-employment compensation (whether you will be implementing change-in-control arrangements that you want to submit to a "Say on Pay" vote), and your relationship with your key shareholders.

Advisory Vote on Change-in-Control Arrangements

What Does the Dodd-Frank Act Require?

The Dodd-Frank Act requires public companies, in connection with any shareholder vote on a merger, acquisition, or other change-in-control transaction to (i) disclose any arrangements that will provide any named executive officer with payments or benefits in connection with the transaction, as well as the amounts payable under these arrangements, and (ii) conduct a non-binding shareholder advisory vote on these arrangements (unless the arrangements have previously been subject to a general "Say on Pay" vote). This vote is non-binding on the company and its board of directors – specifically, the vote may not be construed as:

- Overruling a decision by the board of directors
- Creating or implying any change in or additional fiduciary duty for the board
- Limiting shareholders' right to make executive compensation proposals

When Do We Have to Comply?

This new requirement applies to any meeting of shareholders for a merger, acquisition or other change-in-control transaction held after January 21, 2011.

What Should We Being Doing Now?

While this new requirement is situational, you should consider taking the following actions when preparing for your first general "Say on Pay" vote:

- Make sure that you've identified all of your change-in-control arrangements, as the definition of what's covered by the new requirement is fairly broad
- Consider enhancing the disclosure of your existing change-in-control arrangements in the proxy state-

ment for your annual shareholders meeting (including a clear explanation of the rationale for the arrangements) so that there is no question that they are covered by the exception to the vote

Compensation Committee Independence

What Does the Dodd-Frank Act Require?

The Dodd-Frank Act requires that all of the members of the board compensation committee of a stock exchange-listed company (except a controlled company and certain foreign private issuers) be directors and meet specific SEC-established independence standards. These standards must consider the source of compensation received by the director, including any consulting fees, and whether the director is affiliated with the company, any subsidiary, or an affiliate of any subsidiary.

When Do We Have to Comply?

By July 16, 2011, the SEC must direct the national securities exchanges to prohibit the listing of any company that does not meet the new standards. There is no stated deadline for the exchanges to implement this requirement. While both actions could take place this year, we expect that the necessary rulemaking to implement this new requirement won't take place until sometime in 2011.

What Should We Being Doing Now?

Until the SEC and national securities exchanges complete their rulemaking, you should consider taking the following actions now:

- Re-examine your compensation committee member relationships in light of the new standards. While many companies are likely to find that the new standards will not necessitate any changes in committee membership, venture-backed companies may discover that, by virtue of their equity stake in the enterprise, directors representing these investors will be considered "affiliates" of the company and, therefore, not independent
- If you expect that you may not have enough independent committee members, consider increasing the size of the board of directors and recruiting new members

Committee Adviser Independence

What Does the Dodd-Frank Act Require?

The Dodd-Frank Act requires that the board compensation committee of a stock exchange-listed company may only select a compensation consultant, legal counsel, or other adviser after taking into consideration specific SEC-established independence factors (which are to competitively neutral) that include:

- the provision of other services to the company by the person that employs the compensation consultant, legal counsel, or other adviser;
- the amount of fees received from the company by the person that employs the compensation consultant, legal counsel, or other adviser, as a percentage of the total revenue of the person that employs the adviser;
- the policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the board compensation committee; and
- any stock of the company owned by the compensation consultant, legal counsel, or other adviser.

As long as a company conducts an assessment of an adviser's independence, it is free to hire the compensation consultant, legal adviser, or other adviser even if he or she is not, in fact, independent. Thus, the Dodd-Frank Act leaves to the company – and its shareholders – the decision on whether a compensation consultant, legal counsel, or other adviser is an appropriate adviser to the board compensation committee.

Note that the Dodd-Frank Act also requires stock exchange-listed companies to disclose in the proxy statement for their annual shareholders meeting whether the board compensation committee has received advice from a compensation consultant, whether the consultant's work raised any potential conflicts of interest, and, if so, the nature of the conflict and how it was resolved.

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When Do We Have to Comply?

By July 16, 2011, the SEC must direct the national securities exchanges to prohibit the listing of any company that does not observe the new requirement. There is no stated deadline for the exchanges to implement this requirement. While both actions could take place this year, we expect that the necessary rulemaking to implement this new requirement won't take place until sometime in 2011.

What Should We Being Doing Now?

Once again, technical compliance will depend on the SEC and national securities exchange rules. In the interim, companies should evaluate their current adviser relationships (primarily their compensation consultant relationships) to identify any potential discussion points under the factors identified in the Dodd-Frank Act. In addition, you should determine whether to enhance your current disclosure about the use of compensation consultants and other advisers.

Compensation Recovery ("Clawback") Policy

The Dodd-Frank Act requires that stock exchange-listed companies to adopt a compensation recovery policy that:

- requires disclosure of the company's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws; and
- provides that, in the even the company is required to prepare an accounting restatement because of its material noncompliance with any financial reporting requirement under the securities laws, the company will:
  - recover from any current or former executive officer
  - any incentive-based compensation (including stock options) received during the three-year period preceding the date on which the company is required to prepare the accounting restatement
  - based on erroneous data that is in excess of what would have been paid to the executive officer under the accounting restatement

When Do We Have to Comply?

Only when the SEC and national securities exchanges complete the necessary rulemaking to prohibit the listing of any company that does not meet the new requirement. There is no stated deadline for either the SEC or the exchanges to implement this requirement. While both actions could take place this year, we expect that the necessary rulemaking to implement this new requirement won't take place until sometime in 2011.

What Should We Being Doing Now?

There are numerous questions that are going to have to be addressed by the SEC – essentially filling in the details not contained in the statute – to make these "clawback" policies workable. Until then, you should consider taking the following actions now:

- If you do not currently have a compensation recovery policy, you should begin discussions about the scope of your eventual Dodd-Frank-mandated policy (for example, should the triggering events go beyond just a material restatement (which is all that Dodd-Frank requires) to cover other situations, such as the breach of a post-employment covenant and/or an erroneous incentive compensation calculation that does not involve a financial restatement)
- If you already have a compensation recovery policy, you should compare the policy against the specifics of the Dodd-Frank-mandated policy to see if any changes or modifications to your existing policy will be necessary or appropriate
  - also, you should review your current outstanding compensation arrangements, including incentive compensation plans and employment agreements to determine whether any modifications are needed (although it's not clear that the requirement will apply retroactively)
- There are going to be several practical administrative matters that the provision does not address – and which the SEC may not address either – that may require attention (for example, clearly identifying the person or group that will determine whether a triggering event has occurred)

The Dodd-Frank Act Executive Compensation Provisions – What You Should be Doing Now (continued)

- Consider enhancing the disclosure of your 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 your policy stacks up against the Dodd-Frank-mandated policy

Pay-Versus-Performance Disclosure

What Does the Dodd-Frank Act Require?

The Dodd-Frank Act requires public companies to present a graphic (or narrative) depiction of the relationship between the company's financial performance and the compensation paid to the named executive officers in the proxy materials for their annual shareholders meeting.

When Do We Have to Comply?

There is no stated deadline for the SEC to implement this requirement. While action could take place this year, we expect that the necessary rulemaking to implement this new requirement won't take place until sometime in 2011.

What Should We Being Doing Now?

While formal compliance with the new requirement will have to await SEC rules, you should consider taking the following actions now:

- Review past disclosures of your incentive compensation arrangements and consider providing greater disclosure about your compensation policies and alignment to financial performance
- Add an executive summary to your Compensation Discussion and Analysis that addresses this relationship
- Present interim disclosure in your 2011 proxy statement showing the relationship between aggregate named executive officer compensation (based on their total direct compensation as reported in the Summary Compensation Table) and corporate financial performance (based on total shareholder return) over an extended period of time (for example, five years)

Internal Pay Equity Disclosure

What Does the Dodd-Frank Act Require?

The Dodd-Frank Act requires public companies to disclose in all company filings with the SEC the median annual total compensation of their employees (except for the chief executive officer), the annual total compensation of their CEO, and the ratio of the median annual total employee compensation to the annual total compensation of the CEO.

When Do We Have to Comply?

There is no stated deadline for the SEC to implement this requirement. While action could take place this year, we expect that the necessary rulemaking to implement this new requirement won't take place until sometime in 2011.

What Should We Being Doing Now?

As a result of the numerous ambiguities in the stature, formal compliance with the new requirement will have to await SEC rules (and, possibly, technical corrections from Congress). In the interim, you should consider taking the following actions now:

- Present interim disclosure in your 2011 proxy statement showing the ratio of CEO pay (based on his or her total direct compensation as reported in the Summary Compensation Table) to the pay of your other named executive officers (again, based on TDC as reported in the Summary Compensation Table)
- Address the subject of the internal pay equity among your executive officers in the Compensation Discussion and Analysis

Employee-Director Hedging Policy Disclosure

What Does the Dodd-Frank Act Require?

The Dodd-Frank Act requires public companies to disclose in the proxy statement for their annual shareholders meeting whether any employee or director is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of certain specified equity securities. Note that companies are simply required to disclose whether they have such a policy; they are not required to have one.

When Do We Have to Comply?

There is no stated deadline for the SEC to implement this requirement. While action could take place this year, we

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expect that the necessary rulemaking to implement this new requirement won't take place until sometime in 2011.

What Should We Being Doing Now?

Until the SEC completes its rulemaking, you should consider taking the following actions now:

- If you do not currently have a company hedging policy, you should consider adopting a comprehensive hedging policy
- If you already have a hedging policy, you should modify the policy to extend it to all employees (if such coverage does not currently exist) and tailor the policy to the Dodd-Frank Act-mandated requirements

Broker Voting of Uninstructed Shares

What Does the Dodd-Frank Act Require?

The Dodd-Frank Act prohibits broker voting of uninstructed shares in director elections, executive compensation matters, or any other significant matter as determined by the SEC.

When Do We Have to Comply?

This prohibition became effective on July 22, 2010.

What Should We Being Doing Now?

Since it is now in effect, you should analyze your shareholder base to determine whether the new prohibition on broker voting of uninstructed shares on executive compensation matters will have any impact on your upcoming "Say on Pay" vote or another compensation-related matter that will be submitted for shareholder action at your next annual shareholders meeting.

Need Assistance?

Compensia has had significant experience in helping companies ensure that their executive compensation programs satisfy operational and disclosure requirements. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance in assessing their likely impact on your executive compensation plans and arrangements, please feel free to contact us. ■

About Compensia

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