Congress Agrees on Executive Compensation Reforms

On Friday, June 25, 2010, the House-Senate conferees agreed on a final version of major financial services reform legislation. The renamed "Dodd-Frank Wall Street Reform and Consumer Protection Act" now goes to the House of Representatives and Senate this week for final approval, with the goal of presenting the bill to President Obama for his signature by the Fourth of July.

The 2,300+ page bill, the text of which was published this weekend, contains a number of executive compensation and corporate governance reforms. To assist you in monitoring the status of these reforms, we summarize below the relevant provisions from the final version of the Act.

Advisory Vote on Executive Compensation (Section 951)

The Act amends the Securities Exchange Act of 1934 to require 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. In a last-minute surprise, the House-Senate conferees dropped the requirement for an annual vote and, instead, agreed that each company's shareholders can decide whether to conduct a "Say on Pay" vote annually, every two years, or every three years. The Act requires that shareholders be given the

Eight Things You Should Know About the Dodd-Frank Wall Street Reform and Consumer Protection Act

- As expected, the Act mandates a shareholder advisory vote on executive compensation beginning in 2011. However, after an initial vote next year, thereafter companies may conduct a "Say on Pay" vote every year, every two years, or every three years, as determined by shareholders. The Act also mandates an advisory vote on golden parachute arrangements that have not previously been subject to a shareholder vote.
- Compensation committee members must meet new independence standards established by the national securities exchanges.
- Compensation consultants, legal counsel, and other advisers to the compensation committee may be retained only after the committee has considered whether they are "independent" based on factors identified by the SEC. However, engagement of an independent adviser is not required.
- Beginning in 2011, companies will be required to expand their executive compensation disclosure to include (i) the relationship between executive compensation and corporate financial performance, (ii) the ratio between CEO total compensation and the median total compensation of all employees, and (iii) their employee and director equity hedging policies.
- Companies will be required to implement a "clawback" policy requiring current and former executive officers to return erroneously-paid incentive compensation (including stock options) received during the three-year period preceding an accounting restatement due to material noncompliance with any accounting requirement.
- The Act authorizes the SEC to adopt a "proxy access" rule, which the Commission is expected to do later this summer. The provision also makes clear that the SEC may exempt certain companies, such as smaller reporting companies, from any proxy access rule.
- Brokers will be prohibited from voting uninstructed shares for the election of directors, on executive compensation matters (including a "Say on Pay" vote), and for any other significant matter as determined by the SEC.
- The conferees agreed to abandon a provision that would have mandated majority voting for the election of director in uncontested elections. Consequently, majority voting will continue to be addressed on a company-by-company basis.

opportunity to revisit their decision on the frequency of the advisory vote at least once every six years.

In transitioning to this new requirement, in 2011, each public company will be required to conduct:

- A non-binding shareholder advisory vote on its executive compensation program; and
- A separate shareholder vote to decide whether future advisory votes will be held annually, every two years, or every three years.

Initial Observations. The decision to allow for "Say on Pay" votes other than on an annual basis comes as a bit of a surprise, but is consistent with the recent trend of some large companies (such as Microsoft) to provide for such votes on a bi-annual or tri-annual basis. This should enable institutional investors to do a better job evaluating the merits of each company's executive compensation program as they won't be required to review every company's proxy statement each year. The transition to this system promises to be hectic, however, as companies solicit the input of their shareholders next year as to the frequency of the vote.

Advisory Vote on Golden Parachutes

The House-Senate conferees agreed to insert a provision in the Act requiring, in connection with any proxy statement involving a shareholder vote on any merger or other acquisition:

- disclosure of any agreements or understanding with any named executive officer for any compensation that is triggered by the merger or acquisition (including the total amount payable); and
- a separate non-binding shareholder advisory vote on any such agreement or understanding, to the extent not previously subject to the general shareholder advisory vote on executive compensation.

Initial Observations. After flirting with omitting this provision, the conferees agreed to reinsert the golden parachute "Say on Pay" requirement, a provision that was part of the House of Representatives' initial version of the bill. Ultimately, the disclosure requirement may prove to be more problematic for companies than the vote itself since the vote is required only for new agreements or agreements that are modified in advance of a contemplated transaction. Unless subsequently modified, pre-existing agreements will be exempt from a separate vote as long as they were previously subject to the general; "Say on Pay' vote on the company's executive compensation program.

Votes are Advisory Only

The Act makes clear that both the executive compensation and golden parachute votes are not binding on the company or its board of directors, and will not:

- Overrule a decision of the company or its board of directors;
- Create or imply any change to the fiduciary duties of the company or its board of directors;
- Create or imply any additional fiduciary duties for the company or its board of directors; or
- Limit or restrict the ability of shareholders to submit proposals on executive compensation for inclusion in the company's proxy materials.

These new requirements will apply to any annual or other meeting of shareholders that takes place beginning six months after the date the Act is signed into law. The SEC has the authority to exempt certain companies, such as smaller reporting companies, from these new requirements.

Compensation Committee Independence (Section 952)

The Act requires the SEC to direct the national securities exchanges to prohibit the listing of any company issuing equity securities (with certain limited exceptions, including controlled companies and certain foreign private issuers) unless all of the members of its board compensation committee are directors and meet specific independence standards. For this purpose, "independence" is to be determined by SEC rule and 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. The Act also grants the SEC the authority to exempt specific relationships from these requirements, including those of smaller reporting companies.

Initial Observations. As expected, the standard for determining "independence" is similar to the standard currently used for determining audit committee membership

Independence of Committee Advisers

The Act specifies that a board compensation committee may select a compensation consultant, legal counsel, or other adviser only after taking into consideration factors identified by the SEC that affect such adviser's independence. These factors, which are to be competitively neutral, 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 that person's total revenue;
- 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 compensation committee; and
- Any stock of the company owned by the compensation consultant, legal counsel, or other adviser.

Initial Observations. This provision represents a significant relaxation of the initial House proposal, which would have mandated the use of "independent" compensation consultants by board compensation committees. As revised, board compensation committees are free to engage compensation consultants, legal counsel, and other advisers as they see fit, as long as they have considered any potential conflict of interest and taken steps to minimize any potential conflict. Thus, the 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.

Disclosure of Compensation Consultant Engagement

The Act also requires companies to disclose in their annual proxy statements, beginning one year after the date of enactment, whether the board compensation committee has engaged 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 was resolved.

Finally, the Act confirms the authority of the board compensation committee to retain and oversee the work of a compensation consultant, legal counsel, and other advisers and directs companies the provide appropriate funding for these engagements. The Act also grants the national securities exchanges the authority to exempt certain categories of companies, including smaller reporting companies, from these requirements.

Executive Compensation Disclosures (Section 953)

Disclosure of Pay Versus Performance

The Act amends the Securities Exchange Act of 1934 to require public companies to disclose in their annual proxy statements the relationship between the compensation actually paid to their executives and their financial performance, taking into account any change in the value of their shares and any dividends and distributions. This disclosure may be in either graphic or narrative form.

Initial Observations. It's not clear how executive compensation is to be calculated for purposes of this disclosure (for example, on an aggregate or average basis). In addition, corporate financial performance can take many forms. Presumably, the SEC will adopt rules to implement this provision before year-end. In many respects, aspects of this requirement may parallel the current Stock Performance Graph that companies must provide in their glossy annual reports to shareholders.

Pay Ratio Disclosure

The Act directs the SEC to amend its executive compensation disclosure rules to require each public company to disclose in any Securities Act and Exchange Act filing (such as registration statements, periodic reports, and proxy statements):

- The median annual total compensation of all employees (except the CEO);
- The annual total compensation of the CEO; and
- The ratio of the median annual total compensation of all employees to the annual total compensation of the CEO.

For purposes of this requirement, "total compensation" is to be determined under the SEC's executive compensation disclosure rules.

Initial Observations. In many ways, this seemingly innocuous requirement may prove to be the most challenging for companies. Based on a literal reading of the requirement, companies must calculate the total compensation under the SEC's executive compensation disclosure rules for all of their employees, not just their named executive officers. The SEC is likely to explain how this provision is to be implemented as a practical matter when it adopts its enabling rule later this year.

Compensation Recovery Policy (Section 954)

The Act requires the SEC to direct the national securities exchanges to prohibit the listing of any company that does not develop and implement a policy that:

- Discloses a company's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws; and
- Provides for compensation recovery as follows:
  - In the event the company is required to restate its financial statements due to material noncompliance 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 when the company is required to prepare the restatement, based on erroneous data; and
  - recovers the amounts in excess of what would have been paid to the executive officer under the restatement.

Initial Observations. This provision goes farther than Section 304 of the Sarbanes-Oxley Act as it would apply to all executive officers (not just the CEO and CFO) and is not predicated on anyone's "misconduct." However, as drafted, it creates a number of interpretive questions (such as how the amount to be recovered in certain situations is to be calculated) that will have to be addressed by the SEC.

Disclosure of Employee and Director Hedging (Section 955)

The Act amends the Securities Exchange Act of 1934 to require the SEC to promulgate rules requiring proxy statement disclosure of whether a company permits its employees or directors to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset market declines affecting compensatory equity awards or other equity securities held by the employee or director.

Broker Voting (Section 957)

The Act amends the Securities Exchange Act of 1934 to prohibit broker voting of uninstructed shares in director elections, executive compensation matters, or any other significant matter as determined by the SEC.

Initial Observations. This provision appears to be aimed at codifying the recent change to NYSE Rule 452, as well as precluding brokers from voting shares in "Say on Pay" votes. As it also applies to any shareholder vote involving "executive compensation," it could extend to numerous compensation-related matters, such as the approval of severance agreements.

Proxy Access (Section 971)

The Act permits the SEC to adopt a proxy access rule, under which shareholders would be permitted to nominate directors using the company's proxy materials on terms to be determined by the SEC. The Act also expressly notes that the SEC has the authority to exempt certain categories of companies, including smaller reporting companies, from this rule.

Initial Observations. This provision, which was subject to heated debate in the conference, leaves the details of this access provision to the SEC, subject only to the requirement that such access be on terms and conditions as the Commission determines are "in the best interests of shareholders and for the protection of investors." It is expected that, once the Act has been signed into law, the SEC will proceed to adopt a proxy access rule later this summer.

Disclosures Regarding Chairman and CEO Structures (Section 972)

The Act requires companies to disclose in their proxy statements why they have chosen to separate or, alternatively, not to separate the positions of chairman of the board of directors and chief executive officer.

Initial Observations. This provision codifies the SEC's recent amendment to its proxy rules to require companies to provide disclosure about their board's leadership structure, including whether the positions of chairman of the board and CEO are combined or separate, and why the structure is appropriate for the company

Need Assistance?

Compensia has had significant experience in helping companies to design and implement their executive compensation programs. 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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