# New Issues Under the Compensation and Corporate Governance Provisions of the Wall Street Reform Act

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**Winstead News Alert**

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"). The Act is generally intended to address perceived needs for financial regulatory reforms in the financial sector. However, the Act also contains executive compensation and corporate governance rules that apply to most public companies. The purpose of this alert is to address eight new rules that most public companies will need to consider in order to implement the compensation and corporate governance provisions of the Act.

**New Rule #1: Say-on-Pay Shareholder Vote**

Shareholders must be provided with a non-binding advisory vote on the executive compensation disclosed in any proxy, consent or authorization materials for a shareholder meeting for which the SEC rules require compensation disclosure. This vote is required at least once every three years, beginning with the first shareholder meeting that occurs more than six months from enactment of the Act. At the first annual meeting for which say-on-pay is implemented, the shareholders must also vote on whether say-on-pay should be held every one, two or three years; thereafter a vote on frequency must be held by a separate resolution no less often than every six years. Thus, at the first meeting implementing this New Rule #1, shareholders must be provided with both (i) a say-on-pay resolution, and (ii) a separate resolution for shareholders to vote on whether say-on-pay will be held every one, two or three years. The Act specifically authorizes the SEC to exempt certain small issuers.

A say-on-pay vote is non-binding and cannot be construed as (i) overruling compensation decisions of the board, (ii) creating additional fiduciary duties on the board, or (iii) limiting a shareholder's ability to make compensation proposals for inclusion in the proxy. Thus, the Act is not intended to erode the business judgment rule.

**Effective Date:** Applicable to shareholder meetings that occur more than six months following enactment of the Act.

**A Few Issues to Consider:**

- Proxy statements will need to be revised to incorporate the mechanics of a say-on-pay mandate.

- CD&A disclosure will also need to be reviewed for possible changes since shareholders will be voting on the overall compensation disclosed in the CD&A and its tabular disclosure.

- Say-on-pay is likely to increase the influence of shareholder advisory services (e.g., RiskMetrics Group, Glass Lewis). Therefore, a company should revisit its ability to comply with mandates set by such advisory services (e.g., by reviewing change in control policies, employment agreements, separation pay arrangements, etc.). Additionally, companies with a high percentage of retail shareholders should consider implementing ongoing shareholder educational campaigns since retail brokers cannot vote on compensation matters absent specific instructions from the beneficial owners (see New Rule #3, below, for a discussion of restrictions on broker voting).

- Almost all companies that voluntarily included a say-on-pay resolution in their latest annual meeting received a "for vote." However, shareholders of three companies voted against management say-on-pay proposals in the most recent proxy season. The annual meeting held by KeyCorp in May 2010, resulted in 55 percent opposition to its say-on-pay resolution (according to RiskMetrics Group, the company had a disconnect between pay and performance). The annual meeting held by Motorola, Inc. in May 2010, resulted in 54 percent opposition to its say-on-pay resolution (according to RiskMetrics Group, the company had an inappropriate pay for failure arrangement). And the annual meeting of Occidental Petroleum Corp. in May 2010, resulted in successful opposition to its say-on-pay resolution (according to RiskMetrics Groups, the company failed to address performance target issues, did not disclose its peer group and had excise tax gross-up provisions).

**New Rule #2: Separate Say-on-Pay Vote on Golden Parachute Payments**

In addition to the requirements of Rule #1, certain payments to named executive officers in mergers and acquisitions must be described in proxy or consent solicitation materials and submitted to shareholders for their approval in the form of a non-binding shareholder resolution. This resolution must: (i) describe in clear and simple terms any arrangements with named executive officers that are related to the transaction, (ii) describe the aggregate amount of all compensation that will or could be paid to the named executive officers (including any conditions to payment), and (iii) include a separate non-binding advisory vote to approve the payments unless the underlying arrangements have previously been subject to a say-on-pay vote. Consistent with New Rule #1, the non-binding shareholder advisory vote cannot overrule any decision of the board or impose any additional fiduciary duties on the board.

Noteworthy is that a separate say-on-pay vote is not required if the payment in question was previously approved by the company's shareholders under New Rule #1.

**Effective Date:** Applicable to shareholder meetings that occur more than six months following enactment of the Act.

**A Few Issues to Consider:**

- Prior to the upcoming proxy season, a company should consider reviewing the golden parachute payment arrangements it has with named executive officers to determine whether such payments are in alignment with the company's current compensation philosophy. This should include a review of all prospective payments, including payments derived from employment agreements, incentive plans, bonus programs, etc.

- Once the list of prospective payments is compiled, a company should ensure that the payments are adequately disclosed in the CD&A and tabular disclosure in anticipation that they will be subject to a shareholder say-on-pay vote under New Rule #1. If the prospective payments are approved under New Rule #1, a company would not need to seek shareholder approval for such payments at the time of a future merger or acquisition.

**New Rule #3: Prohibits Discretionary Voting by Brokers**

The Act requires the national securities exchanges to prohibit most proxy voting by a broker without voting instructions from the beneficial owners. The prohibited voting applies to election of directors, executive compensation and any other significant matter. Noteworthy is that this prohibition would apply to shareholder votes on say-on-pay.

**Effective Date:** Effective July 21, 2010.

**A Few Issues to Consider:**

- Absent a company-sponsored educational campaign, this rule will likely result in fewer shares of retail shareholders being voted. Thus, a company should analyze the makeup of its shareholders to determine the likely impact of this new rule (e.g., a company with stock held mostly by retail shareholders could be more negatively impacted than a company with primarily institutional shareholders).

- Assuming retail shareholders typically vote with management, it would follow that the influence of institutional shareholder advisory services could be disproportionately increased if the beneficial owners of the company do not provide voting instructions to the retail shareholders.

- Therefore, a company needing retail shareholder votes should consider whether an educational outreach campaign should be developed to target the beneficial owners and inform them that a failure to provide specific instructions to the broker is the equivalent of a "no vote."

**New Rule #4: Compensation Clawback Policies**

As a listing requirement, national securities exchanges will require companies to implement clawback policies (a.k.a. recoupment policies) that are more expansive than current requirements under Section 304 of the Sarbanes-Oxley Act ("Section 304"). This policy should be disclosed in the proxy. Under the Act: (i) the clawback policy must be triggered any time the company prepares an accounting restatement resulting from material noncompliance with any financial reporting requirement (in contrast, Section 304 applies only when a restatement of financial statements is “required” and is the result of “misconduct”); (ii) once the clawback policy is triggered, it would apply to all incentive-based compensation paid to current and former executive officers (in contrast, Section 304 applies only to the CEO and CFO); and (iii) the look back period for which incentive-based compensation is subject to clawback is the three-year period preceding the date on which the restatement is required (in contrast, the look back period under Section 304 is twelve months). The amount subject to the clawback is the difference between the amount paid and the amount that should have been paid under the accounting restatement.

**Effective Date:** No deadline was provided within which national securities exchanges must implement this rule.

**A Few Issues to Consider:**

- Current clawback policies should be revisited to determine what changes would be required under the Act.

- Determine “who” should be responsible for clawback enforcement (e.g., a risk assessment officer, the compensation committee, the full board of directors) and what repayment procedure should be used once a clawback is triggered.

- Determine whether the clawback policy should be more expansive than required under the Act. For example, consider adding more events that would trigger the clawback than currently required under the Act, such as poor performance, violation of noncompetes, negligence, etc. One reason for a strong clawback policy is that it can act as a mitigating factor to negate risk assessment disclosure under recent SEC rules (which require narrative disclosure of compensation policies and practices that are “reasonably likely” to have a “material adverse effect” on the company). Plus, a strong clawback policy acts as positive CD&A disclosure.

- The above should involve a current analysis and review of all compensation arrangements between a company and its executive officers (e.g., employment agreements, bonus arrangements, equity awards) to ensure proper integration between such arrangements and a company's new clawback policy.

**New Rule #5: Compensation Committee Independence**

The Act requires national securities exchanges to prohibit the listing of the securities of any company whose compensation committee is not comprised exclusively of independent directors. In addressing "independence," the exchanges would have to identify applicable factors, such as (i) whether the director received income from the company other than director compensation, and (ii) the relationship of the director to the company and/or any of its subsidiaries or affiliates.

**Effective Date:** National securities exchanges are required to implement this New Rule # 5 within 360 days from July 21, 2010.

**A Few Issues to Consider:**

- Prior to the Act, the only requirement under applicable listing rules, Rule 16b-3 and Section 162(m) was that at least two members of the compensation committee qualify as independent. This allowed directors who were not independent to serve on the compensation committee so long as at least two directors were independent.

- A company should revisit, and if necessary, restructure the composition of its compensation committee to assure all of its members are independent.

**New Rule #6: Independence of Compensation Committee Advisers**

The Act provides that compensation committees must have the authority (and be funded) to obtain and oversee independent legal counsel and other advisers after taking into consideration certain factors to be identified and established by the SEC. Factors include: (i) the amount of fees received by the consultant from the company as a percentage of the consultant’s total revenue, (ii) the policies and procedures of the consultant’s employer that are designed to prevent conflicts of interest, (iii) any relationship (business or personal) between the consultant and any member of the compensation committee, (iv) the amount of other services the consultant provides to the company, and

(v) any company stock owned by the consultant. Noteworthy is that the Act does not require consultants to be independent.

In accordance with rules to be established by the SEC, a company must disclose: (i) whether a consultant was retained by the compensation committee, (ii) whether the work performed by the consultant created a conflict of interest, and (iii) how any conflict is being addressed by the company.

**Effective Date:** Generally, one year following July 21, 2010.

**A Few Issues to Consider:**

- The recently finalized SEC rules addressing conflicts of interest with compensation consultants continue to apply. Those rules generally require additional CD&A disclosure if the consultant was paid by the company for “additional services” (generally defined as being paid $120,000 or more during the fiscal year).

- However it appears the perceived conflict of interest associated with paying a consultant “additional services” could be negated if the consultant’s employer has sufficient policies and procedures in place to prevent conflicts of interest. This could act as positive disclosure for those companies who use large multi-disciplinary consulting shops.

**New Rule #7: Proxy Access Authorized for SEC Consideration**

The Act authorizes, but does not require, the SEC to issue proxy access rules (i.e., the ability of shareholders to provide director nominees in proxy materials). The Act specifically authorizes the SEC to exempt certain small issuers.

The SEC currently has proposed rules on proxy access. Thus, it is likely the SEC will adopt some form of proxy access soon.

Noteworthy is that the SEC recently published its Concept Release on the U.S. Proxy System generally focusing on the following three issues: (i) accuracy and transparency of the voting process, (ii) communication between the shareholders and the company, and (iii) the relationship between voting and economic power. See http://www.sec.gov/rules/concept/2010/34-62495.pdf

**New Rule #8: Additional Proxy Disclosure**

Under the Act, the SEC must require the following additional compensation-related proxy disclosure:

- The relationship between the financial performance of the company and the compensation actually paid to its named executive officers, taking into account stock price, dividends and other distributions. This could be disclosed by using a graph or pictorial.

- A comparison of the CEO’s annual total compensation against the median total annual compensation of all employees (other than the CEO), to be disclosed in the form of a ratio. In practice, companies will likely find it challenging to implement this comparison. For example, the CEO's total compensation in the summary compensation table includes dollar amounts that are not likely recognized as gross taxable income for that specific year (e.g., the fair value of stock-based awards is included in the summary compensation table on the grant date even though the compensation element would not likely be recognized by the CEO as gross taxable income for that same year). Thus, a comparison will likely be burdensome because the same rules are not applicable to non-CEO employees unless the company first sets up an internal reporting mechanism applicable to non-CEO employees.

- Whether any employees (not just the named executive officers) or directors can hedge against decreases in the value of compensatory stock they directly or indirectly hold.