



JAMES F. REDA EXECUTIVE COMPENSATION ALERT

Dodd-Frank Act Will Require Changes to Executive Compensation Proxy Disclosures and Practices

James F. Reda & Associates Recommends the Actions to Take Now

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). Although Dodd-Frank primarily addresses the overhaul of the national financial regulatory system, it also contains corporate governance, executive compensation, disclosure, and other provisions that apply to public companies.

This alert addresses only those provisions that are generally applicable to public companies, which include providing the SEC with authority to implement proxy access, mandating shareholder advisory votes on executive compensation and “golden parachutes,” enhancing compensation committee and adviser independence requirements, mandating executive compensation clawbacks, and increasing disclosure in proxy statements. Importantly, Dodd-Frank does not require public companies to implement a majority voting standard in uncontested elections for directors as had been included in some prior versions of the legislation.

In general, the Congress (and the President) has crafted language in this bill that is subject to interpretation. Some of these new rules will cause changes to the exchange listing rules, but most others will be SEC rules. Most of these rules will apply to the 2011 proxy season (most notably Say-On-Pay), while others will not be issued in time and will be applicable to the 2012 proxy season (e.g., consultant independence).

Some of these new rules will result in major changes with not much cost or disruption to the company such as independence of compensation committee members to make them more aligned with audit committee member independence. Others, however, are insidious such as the CEO Pay to Company-wide Median Pay ratio requirement that will require substantial work on the part of large multi-national companies to comply.

About James F. Reda & Associates, LLC

James F. Reda & Associates, LLC is an independent executive compensation consulting firm. Our principal consultants have over 75 years of combined experience in compensation consulting and frequently are quoted in leading media publications such as BusinessWeek, Forbes, Fortune, The New York Times, and The Wall Street Journal.

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Timing and Actions to Take Now

Most of the provisions in Dodd-Frank relating to corporate governance, executive compensation, and disclosure require rulemaking by the SEC or national securities exchanges. We believe it is likely the SEC will adopt rules implementing these provisions so that they are applicable for the 2011 proxy season. In addition, the say-on-pay vote on executive compensation requirement will become effective six months after the enactment of Dodd-Frank without SEC rulemaking and thus will be applicable to most annual meetings in 2011. While public companies may not be able to make final decisions regarding matters subject to SEC rulemaking until final rules are available, public companies and their boards of directors should begin now to review and consider the matters discussed in this alert, as there may be only a short time period between the SEC adopting final rules and the 2011 proxy season:

- ***Compensation Committee and Adviser Independence.*** Companies will need to update their compensation committee charters once final rules become available. In the meantime, companies also should be considering the independence of their compensation committee members and compensation consultants and other advisers to determine if changes will need to be made.
- ***CEO to Company-wide Median Pay Ratio.*** Companies should assess their HRIS system to determine how they will comply with this new rule.
- ***Compensation Clawbacks.*** Companies will need to adopt new policies or update existing policies once final rules on compensation clawback provisions become available. Companies should be considering now what changes will need to be made in light of the provisions in Dodd-Frank.
- ***Proxy Access.*** Companies will need to revise advance notice provisions in their bylaws to comply with the provisions of the SEC's final rules on proxy access, when and if adopted, and may want to use this opportunity to otherwise confirm that such provisions are up to date.
- ***Say-on-Pay Vote on Executive Compensation.*** Companies should begin now to be proactive with shareholders in discussing their executive compensation programs, to consider that shareholders will have a vote when making compensation decisions, and to think about what they will say in their say-on-pay disclosure in their proxy statements. While the shareholder vote on compensation is only advisory, the results of that vote may impact whether shareholders withhold votes for compensation committee members in director elections, which is of particular note for companies that have adopted majority voting. In addition, the say-on-pay vote would require a company to file a preliminary proxy statement with the SEC at least 10 days in advance of mailing the definitive proxy statement, which would impact a company's annual meeting timetable, unless the SEC adopts rules to exempt companies from having to file a preliminary proxy statement for such a vote (which the SEC did for companies receiving TARP funds).

James F. Reda Explains the Dodd-Frank Provisions

■ **SAY-ON-PAY:** At least every three years – or more frequently if determined by shareholders – public companies must solicit a nonbinding shareholder vote to approve the compensation of their named executive officers. The first say-on-pay approval (including a separate vote on the frequency of say-on-pay voting) is required beginning with shareholder annual meetings occurring on or after January 21, 2011. While this vote is “non-binding,” we expect that shareholder sentiment and company desire to avoid a “no” vote will significantly impact future compensation practices. We also expect that the “frequency vote” (required next year and at least once every six years thereafter) will be a hot issue at some companies.

■ **INDEPENDENCE OF COMPENSATION COMMITTEE ADVISERS:** The compensation committee is authorized – but not required – to retain, direct and pay the committee’s own legal counsel, compensation consultants and other advisers independent of those advisers retained by management. Companies must provide appropriate funding to pay those advisers, as determined by the compensation committee. When selecting advisers, compensation committees are required to consider adviser independence. Similar to updates to the proxy disclosure rules adopted by the SEC in December 2009, these factors include:

- Other services provided to the company by the advising firm;
- The amount of fees paid by the company to the advising firm compared to the advising firm’s overall fees;
- Policies and procedures of the advising firm that are designed to prevent conflicts of interest;
- Any business or personal relationship of the individual adviser or advising firm with a member of the compensation committee; and
- Any stock ownership of the company by the individual adviser or advising firm.

This requirement is intended to mitigate the risk or the appearance of conflicts of interest by professionals advising compensation committees on matters relating to executive compensation.

This rule, along with the conflicts disclosure rule adopted by the SEC last December, has caused, and is likely to continue to cause, benefits administration and actuarial firms to divest their executive compensation practices to avoid these conflicts. In addition, it is likely that many compensation committees will rely less on in-house expertise. We also expect an increase in the use of multiple consultants weighing in on a company’s executive compensation matters.

This requirement will become effective after the SEC has issued rules (due by July 17, 2011) and such rules have become effective at the various listing exchanges.

■ **DISCLOSURE OF CEO PAY TO COMPANY-WIDE MEDIAN PAY RATIO:**

Dodd-Frank requires annual disclosure of (1) the median “total compensation” (determined by the SEC proxy disclosure rules under Item 402 of Regulation S-K as in effect on July 20, 2010) of all employees of the company, (2) the total compensation of the CEO, and (3) the ratio of the two numbers. Similar information has been frequently sought by groups via shareholder proposals.

This rule will require that a total compensation profile be created for each employee to include salary, bonus paid (for year that it was earned), grant date value of long-term incentive awards, increase in value of pension benefits and the value of benefits and perquisites. The methodology used to make this calculation was frozen as of July 20, 2010; therefore, as the proxy disclosure rules change (as they have repeatedly since 1993), the calculation method for this ratio will not.

Beyond the data collection burden associated with determining the median total compensation of all employees, we anticipate this provision will have a profound effect on companies’ reviews of their executive compensation philosophy and disclosures to explain the pay differential.

This requirement will become effective when the SEC amends its executive compensation disclosure rules under Item 402. No deadline is contained in Dodd-Frank. We expect this will apply to the 2011 proxy season unless business groups (as expected) lobby for more time to implement this costly provision.

■ **PROXY ACCESS:** Dodd-Frank allows the SEC to move forward with its proxy access project, which will permit shareholders to submit nominees as directors, subject to procedures established by the SEC.

Dodd-Frank provides express authority for the SEC to promulgate rules requiring inclusion of shareholder nominees for director in the issuer's proxy solicitation materials and establishing the procedures to be followed by the issuer in relation to that solicitation. House and Senate conference members discussed, but did not include in the Act, minimum share ownership thresholds or holding periods for shareholders seeking to nominate directors, leaving the SEC to address these issues through rulemaking.

While the Act does not require the SEC to take action with respect to proxy access rules, we expect the SEC to do so in the near future. The SEC proposed rules in June 2009 that would establish proxy access, and SEC Chairman Mary Schapiro stated in a June 2010 speech that she was committed to bring a proposal for final proxy access rules to the SEC so that they would be in effect for the 2011 proxy season.

SEC Commissioners will vote on August 24th on whether to let investors nominate board members on company ballots.

■ **SHAREHOLDER VOTE ON “GOLDEN PARACHUTES”:** Similarly, any transaction proxy statement must include a non-binding shareholder vote to approve named executive officer compensation that is based on or otherwise related to the transaction, unless the compensation was previously subjected to a regular say-on-pay vote. This vote is required beginning with shareholder “transaction” meetings occurring on or after January 21, 2011.

■ **DISCLOSURE OF RELATIONSHIP OF PAY TO PERFORMANCE:**

Information showing the relationship between executive compensation actually paid and the total shareholder return of the company for the applicable period must be included in the annual meeting proxy statement. This requirement may result in a shift back towards long-term compensation tied to company share price fluctuations, such as stock options or stock-settled SARs.

No further information is provided in Dodd-Frank such as which executives are to be included and the applicable time period. This requirement will become effective in accordance with regulations to be issued by the SEC. No deadline is contained in Dodd-Frank.

■ **INDEPENDENCE OF COMPENSATION COMMITTEE MEMBERS:** Dodd-Frank now requires that all compensation committee members be “independent,” applying similar standards to those currently applied to audit committee members. There are narrow exceptions for certain companies exempted by the SEC and for “controlled companies” having more than 50% of the voting power held by an individual, a group, or another issuer. This requirement will become effective after the SEC has issued rules (due by July 17, 2011) and such rules have become effective at the various listing exchanges.

■ **CLAWBACKS:** Although initially fashioned as a requirement to simply disclose “clawback” policies, Dodd-Frank directs the SEC to issue rules requiring the national stock exchanges to mandate that their listed companies establish a policy to recover (i.e., clawback) incentive compensation (including stock options) from current or former executive officers in certain cases following a restatement of financial results. If a company files a restatement that discloses a material noncompliance with any financial reporting requirement, the clawback applies to incentive compensation that was based on the erroneous financial statements and was paid during the three-year period preceding the date the restatement is required. This provision is substantially similar to the clawback requirements applicable to financial institutions receiving government funds under the federal TARP program. No deadline is contained in Dodd-Frank stating when the SEC must issue its rules.

■ **DISCLOSURE OF HEDGING POLICY:** Companies will also be required to disclose any company policy permitting employees or directors to purchase derivative financial instruments (e.g., swaps and collars) that are designed to hedge or offset any decrease in the market value of the company's equity securities granted to or otherwise held by the employee or director. This rule does not require companies to disclose, or to specifically monitor or regulate, actual hedging transactions. Companies with insider trading policies that are silent on this point will likely look to clarify their policies one way or the other. The rule will become effective when the SEC issues its rules. No deadline is contained in Dodd-Frank.

■ **ENHANCED COMPENSATION STRUCTURE REPORTING:** By April 21, 2011, federal regulators must issue rules or guidance requiring "covered financial institutions" with at least \$1 billion in assets to disclose to the appropriate federal regulator the structure of all incentive-based compensation arrangements offered at such institutions, for the regulator to determine if these arrangements provide executives, employees, directors and principal shareholders with excessive compensation, fees, or benefits, and/or could lead to material financial loss to the covered financial institution. Also by April 21, 2011, the regulators are required to issue guidelines or regulations that prohibit incentive arrangements or features that provide excessive compensation or could lead to material financial loss. This mandate has greater reach than the final guidance on sound incentive compensation jointly issued by the Fed, FDIC and OCC in June 2010. Covered financial institutions include banks, broker-dealers, investment advisers, credit unions and Fannie Mae and Freddie Mac.

■ **DISCLOSURE OF SEPARATE CHAIRMAN CEO POLICY:** While not an executive compensation matter per se, Dodd-Frank requires the SEC to issue rules by January 17, 2011 requiring company disclosure of the reasons why the company has or has not separated or combined the positions of CEO and board chair. Presumably, the SEC will need to revisit, and most likely revise, Item 407(h) of Regulation S-K, which was adopted in December 2009 and which requires companies to disclose only why the company determined that the leadership structure is appropriate.

■ **BROKER VOTE:** Dodd-Frank prohibits discretionary voting by brokers with respect to executive compensation, director elections, or any other significant matter as determined by the SEC. To vote, brokers must obtain direction from the beneficial owner of the shares. NYSE Rule 452 already prohibits broker-dealers from discretionary voting in routine director elections and on equity plan proposals. Because NYSE Rule 452 governs broker-dealers, the prohibition affects all public companies that have shares held in street name, not just NYSE-listed companies. Dodd-Frank now also prohibits brokers from voting in their discretion on any "executive compensation" proposals, which would include say-on-pay resolutions or golden parachutes, as discussed above. The result of this rule change will be to make it more difficult for management to get a positive vote on items that require shareholder vote such as say-on-pay.