



Dodd-Frank Wall Street Reform & Consumer Protection Act

By Todd Leone, Gayle Appelbaum, Jim Bean, & Chris Richter
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On July 21, 2010, the Dodd-Frank Wall Street Reform & Consumer Protection Act (the "Act") was signed into law. This legislation of more than 2,300 pages includes a number of provisions affecting executive compensation and corporate governance. While a majority of the compensation provisions apply to all public companies, a few select provisions apply to all financial institutions (public or private) with assets of \$1 billion and more. This client alert summarizes these provisions and the associated effective dates.

Executive Summary

- **Shareholder vote on executive compensation:** For shareholder meetings occurring after January 21, 2011, all proxy-filing public companies are now required to have a non-binding "say-on-pay" vote covering the compensation of the named executive officers. There are two provisions of this requirement. First, once every six years, the public company must ask its shareholders how often it would like to vote on executive pay – every one, two or three years. Second, at least once every three years, companies must provide for the actual advisory vote on executive compensation.
- **Shareholder approval of golden parachutes:** In any merger, acquisition, consolidation, or distribution of a majority of a company's assets, public companies must permit a non-binding shareholder vote on any golden parachutes for any named executive officers. The legislation considers "golden parachute" to be any compensation related to the event. Beginning after January 21, 2011, the advisory vote is required for shareholder meetings at which shareholders are asked to approve such events.
- **Compensation committee independence:** There are now legislated standards with respect to compensation committee independence for public companies. This portion of the Act requires the national security exchanges to develop a definition of independence taking into account the compensation of the director and any affiliations. In addition, the compensation committees of public companies are required to be able to hire independent compensation consultants and legal counsel and must be provided with appropriate funding to do so.
- **Executive compensation disclosures:** The SEC is directed to develop rules for the clear disclosure of executive compensation at public companies. While there is no stated timeframe for the rulemaking, we expect the rules will be in place for the 2011 proxy season. Two new disclosure items are required:
 - **Pay vs. Performance Exhibit:** An exhibit that depicts executive compensation paid related to total shareholder return. This performance exhibit has not yet been defined.
 - **CEO Pay Test:** The disclosure of the ratio of the total compensation of the CEO to the median total compensation for other employees.
- **Recovery of erroneously awarded compensation:** Also referred to as "clawbacks," there is a new requirement in the event of a material restatement



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of earnings for a mandatory three-year look-back to recover excess compensation. Applies to both current and former executive officers at companies listed on a national securities exchange.

- **Financial Institution Compensation Reporting & Prohibitions:** This section applies to any financial institution (e.g., banks & credit unions) with assets over \$1 billion. There are two requirements—both to be defined by April 21, 2011. First, financial institutions will be required to disclose incentive arrangements to their Federal regulator. Second, certain compensation arrangements will be prohibited. The focus is on compensation arrangements that are either excessive or could lead to a material loss.

1. Shareholder Approval of Executive Compensation

Section 951 of the Act requires a shareholder vote on executive compensation. Importantly, the shareholder vote is a “non-binding vote” which does not directly impact executive compensation or overrule decisions made by the company.

- **Vote Requirement:** At least once every three years, a public company subject to the proxy rules must request a shareholder vote on executive compensation.
- **Vote Frequency:** At least once every six years, the company must have a separate shareholder vote on whether the shareholder approval of executive compensation should occur once every one, two, or three years.
- **Effective Date:** The first annual or other shareholder meeting occurring 6 months after implementation of the Act (January 21, 2011).
- **Exemption:** The SEC is to consider if the requirements of Section 951 disproportionately burden small companies and has the authority to exempt a company or class of companies.
- **Institutional Investors:** At least annually, institutional investment managers shall report how they voted
- **McLagan Comment:** While this is a non-binding vote, a majority of “no” votes is highly likely to result in conversation at the compensation committee and should not be ignored.

2. Shareholder Approval of Golden Parachutes

Section 951 of the Act requires shareholder approval of golden parachute compensation. This is also a non-binding vote similar to the shareholder vote on executive compensation. The definition of golden parachute for this purpose covers any compensation that is subject to a Change-in-Control event (see below). This provision requires the SEC to release regulations describing the type of disclosure required.

- **Vote Requirement:** At any meeting where shareholders are asked to approve an acquisition, merger, consolidation or sale/distribution of substantially all the assets (a “CIC event”), there must be a separate shareholder resolution requesting approval of any compensation that is based on or related to the CIC event.
- **Effective Date:** The first meeting occurring after January 21, 2011 where shareholder approval is necessary to approve the CIC event.
- **Exception:** If the compensation that is contingent upon the CIC event has explicitly been approved as a part of the regular shareholder approval of



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executive compensation, no vote is required.

- **Exemption:** The SEC is to consider if the requirements of Section 951 disproportionately burden small companies and has the authority to exempt a company or class of companies.
- **Institutional Investors:** At least annually, institutional investment managers shall report how they voted

3. Compensation Committee - Independence Definition

Section 952 states that each member of the compensation committee is to be (a) a member of the board of directors and (b) independent. The national securities exchanges are charged with defining "independence," and are to include factors such as the source of compensation to a director (including consulting, advisory or other fees paid by the company) and whether the director is affiliated with the company, subsidiary or an affiliate.

- **Exemption:** The national securities exchanges may exempt a particular relationship taking into consideration the size of the company and other factors.

4. Compensation Committee - Independence of Outside Advisors

Section 952 provides that the compensation committee may only select a compensation consultant, legal counsel, or other advisor after taking into account rules to be developed by the SEC. Those rules are to include: factors that are competitively neutral, the provision of other services provided by the consultant/advisor's firm, amount of fees paid to the consultant/advisor's firm as a percentage of the firm's total revenue, policies and procedures of the firm designed to prevent conflicts of interest, any personal or business relationship of the consultant/advisor with a member of the compensation committee, any stock of the issuer owned by the consultant/advisor.

5. Compensation Committee - Authority Relating to Outside Advisors

Section 952 also provides explicit authority to the compensation committee to select and engage compensation consultants, legal counsel, and other advisors. The compensation committee is to be directly responsible for the appointment, compensation, and oversight of the work of the consultants and advisors. Companies are instructed to provide appropriate funding as determined by the compensation committee for payment of reasonable compensation to compensation consultants and other advisors.

- **Construction:** The rules of Section 952 state that the compensation committee (a) is not obligated to follow the advice, implement or act consistently with the advice or recommendations of the advisors, (b) can exercise its own judgment in fulfilling its duties (it does not have to hire an outside advisor).

6. Compensation Committee - Disclosure of Use of Compensation Consultant

Section 952 requires that companies must disclose whether the compensation committee retained or obtained the advice of a compensation consultant. Companies must also disclose if the work of the compensation consultant has raised any conflict of interest, including the nature of the conflict and how it is being addressed.

- **Effective Date:** The first annual or other shareholder meeting occurring after July 21, 2011 (one year after implementation of the Act).



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7. Compensation Committee – General Provisions Covering All Compensation Committee Requirements

The following topics cover all aspects of Section 952 within the Act.

- **Compliance:** By July 16, 2011 (within 360 days of the Act), the SEC is required to release rules directing national securities exchanges to prohibit listing companies whose compensation committees are not in compliance with requirements of Section 952. Procedures will be developed to provide companies with a reasonable opportunity to cure any deficiencies.
- **Exemption:** National securities exchanges/associations have authority to exempt a category of companies, taking into account the potential impact of the requirements of Section 952 on smaller reporting companies.
- **Controlled Company Exemption:** Section 952 does not apply to listed companies that hold elections for directors where more than 50% of the voting power is held by an individual, group, or another issuer.
- **Study & Report:** The SEC is to conduct a study and review of the use of compensation consultants and the effects of such use and submit a report to Congress before July 21, 2012.

8. Pay versus Performance Exhibit

Section 953 requires that the proxy include a clear description of total compensation for executive officers, including a description of the relationship between executive compensation actually paid and the financial performance of the company as reflected by total shareholder return (change in value of share price including dividends and distributions). This disclosure may include a graphic representation of the information.

- **Executive Officers Definition:** The definition of executive officers is to be defined by the SEC, but likely refers to the “named executive officers” (NEOs) required to be reported in a company’s proxy statement.
- **Total Compensation Definition:** While the provision requires compensation to be disclosed pursuant to the existing proxy reporting rules, the SEC is required to release rules clearly describing the disclosure procedures for these amounts.
- **Effective Date:** While there is no effective date for this provision, the SEC is charged with developing rules.
- **McLagan Comment:** We anticipate this provision will be effective for proxies filed in 2011 after a certain date, e.g., it may be effective for proxies filed six months after implementation of legislation (January 21, 2011). However, without a timeframe defined in the legislation, this is yet to be seen.

9. CEO Pay Test Exhibit

Section 953 also requires a new pay disclosure of the ratio of the CEO’s total compensation to the total compensation of all other employees. The SEC is directed to release regulations describing the disclosure procedures.

- **Non-CEO Employee Pay:** Use of the median, not average, total compensation of all other employees is required.
- **Total Compensation Definition:** The definition of total compensation is defined through the existing proxy rules for the Summary Compensation Table.



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- **Effective Date:** While there is no effective date for this provision, the SEC is charged with developing rules.
- **McLagan comment:** There is no requirement to compare the resulting ratio “to market” or to dictate a ratio which is either “too high” or “too low.” It is likely this new disclosure item will create a new metric which will receive attention from compensation committees, institutional investors, shareholders, and the media. In addition, similar to the Pay for Performance Test—which does not have a defined timeframe—we anticipate this provision will be effective for proxies filed in 2011 after a certain date.

10. Recovery of Erroneously Awarded Compensation (“Clawbacks”)

Section 954 requires that companies have a formal clawback policy that is triggered as the result of an accounting restatement due to material non-compliance with financial reporting requirements. The clawback must allow for the recapture of excess compensation to any current or former executive that would not have been paid based upon the restatement for the previous three years.

- **Compliance:** Securities exchanges must prohibit listing of securities of companies that fail to comply.
- **Requirement:** A company must (a) disclosure its policy on incentive based compensation based on financial information required to be reported under securities laws, and (b) if there is a restatement, implement the policy (the “clawback”) to recover incremental compensation.
- **Effective Date:** While there is no effective date for this provision, the SEC is charged with developing rules.
- **Executive Officer Definition:** There is no definition of executive officer provided; however, it is likely that this provision will cover named executive officers (NEOs).

11. Employee & Director Hedging Disclosure

Section 955 of the Act requires the SEC to adopt rules requiring proxy disclosure whether any employee, director, or their designees are permitted to purchase hedging instruments, including: prepaid variable forward contracts, equity swaps, collars, and exchange funds. The provision applies to equity grants as compensation as well as other equity of company they may hold directly or indirectly.

- **Effective Date:** While there is no effective date for this provision, the SEC is charged with developing rules.

12. Voting by Brokers

Section 957 prohibits voting by brokers, unless explicitly instructed by the beneficial owner of the security, on matters related to executive compensation, election of directors, and any other significant matter identified by the SEC.

- **McLagan Comment:** The NYSE previously eliminated voting by brokers for director elections.

13. Board Chair and CEO Structure

Section 972 requires public companies to disclose their rationale for (a) having one person serving as both the board chair and chief executive officer (CEO), or (b) having separate individuals serving in each of the two roles. This will result in a disclosure item regardless of the arrangement in place at a given company.



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- **Effective Date:** The SEC is to prescribe regulations no later than January 21, 2011 (180 days after implementation of the Act).

14. Enhanced Compensation Reporting and Compensation Prohibitions for Financial Institutions

Section 956 of the Act includes two important provisions which apply *to all covered financial institutions*, public or private, that have assets greater than \$1 billion. First, each institution is required to report all incentive compensation arrangements to their Federal regulator. Second, the Act requires the Federal regulators to jointly prescribe regulations that prohibit incentive compensation arrangements or features of such arrangements that encourage inappropriate risks. Both provisions are focused on incentive compensation arrangements that (a) are viewed as excessive, or (b) could lead to a material loss to the covered financial institution.

- **Application:** This applies to incentive-based compensation arrangements for an executive officer, employee, director or principal shareholders. The notion of compensation applies to compensation, fees or benefits. The reporting requirements will not require the disclosure of particular individuals.
- **Exemptions:** Section 956 *does not* apply to either (a) financial institutions with assets less than \$1 billion, or (b) financial institutions that do not have incentive-based pay arrangements.
- **Effective Date:** Federal regulators are directed to jointly prescribe regulations no later than April 21, 2011 (9 months after implementation of the Act).
- **Enforcement:** Section 956 is enforced under the Gramm-Leach-Bailey Act.
- **Federal Regulators:** Federal Reserve, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, National Credit Union Administration, the Securities and Exchange Commission, the Federal Housing Finance Agency
- **Covered Financial Institutions:** Depository institutions, broker-dealers, credit unions, investment advisors, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and any other financial institution that the Federal Regulators determine

15. Prohibition on Steering Incentives (Residential Mortgages)

Section 1403 of the Act prohibits mortgage lenders from receiving compensation, directly or indirectly, based on the terms of a residential mortgage loan. Incentives may be based on the amount of loan principal as well as the number of loans originated. ■



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16. Implementation Dates of the Various Legislated Items

Legislative Item	Effective Date	Companies Covered	Comments
1. Shareholder Approval of Executive Compensation	January 21, 2011 (6 months)	Public companies subject to proxy rules	Shareholder meetings on or after date
2. Shareholder Approval of Golden Parachutes	January 21, 2011 (6 months)	Public companies subject to proxy rules	Change-in-control events on or after date
3. Compensation Committee Independence	July 16, 2011 (360 days)	Listed companies, with limited exceptions	SEC to develop rules by date
4. Compensation committee use independent compensation consultants, legal counsel and other advisors	July 16, 2011 (360 days)	Listed companies, with limited exceptions	SEC to develop rules by date
5. Compensation Consultant Disclosure	July 21, 2011 (1 year)	Listed companies, with limited exceptions	Shareholder meetings on or after date
6. Pay versus Performance Exhibit	Not specified	Public companies subject to proxy rules	SEC to develop rules
7. CEO Pay Test	Not specified	Public companies subject to proxy rules	SEC to develop rules
8. Recovery of Erroneously Awarded Compensation ("Clawbacks")	Not specified	Listed companies	SEC to develop rules
9. Employee & Director Hedging Disclosure	Not specified	Public companies subject to proxy rules	SEC to develop rules
10. Board Chair and CEO Structure	January 17, 2011 (180 days)	Public companies subject to proxy rules	SEC to develop rules by date
11. Enhanced Compensation Reporting and Compensation Prohibitions for Financial Institutions	April 21, 2011 (9 months)	Covered Financial Institutions as defined	Federal regulators to prescribe rules by date
12. Prohibition on Steering Incentives: Mortgage Lending	Not specified	Residential Mortgage Originators	Federal Reserve Board to develop rules



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