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COVINGTON & BURLING LLP

# ADVISORY | Dodd-Frank Act

July 21, 2010

## EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act includes a number of provisions aimed at greater shareholder and regulatory oversight of executive compensation. Among other things, the Act gives shareholders of public companies a "say-on-pay" vote on the compensation of their companies' executives and enhances the power of regulators to restrict executive compensation at a variety of financial firms. The Act also includes provisions that will affect corporate governance practices at many public companies.

Many of the changes described in this advisory will be implemented through SEC rulemaking and revisions to listing standards by national securities exchanges. Annex A provides a summary of the various rulemakings and applicable deadlines, if any, under the Act.

### Key Executive Compensation and Corporate Governance Provisions

- Requires public companies to provide their shareholders a non-binding vote on the compensation of their executives and on "golden parachute" severance arrangements.
- Confirms SEC's authority to adopt rules requiring public companies to include director nominees submitted by shareholders in the company's proxy materials.
- Strengthens standards relating to independence of listed public companies' compensation committees and advisers to such committees.
- Requires listed companies to adopt policies requiring recovery of compensation paid to executives when it is later shown that the compensation was based on erroneous financial results ("claw backs").
- Mandates disclosure by public companies of median annual total compensation of all employees and CEO's annual total compensation.
- Expands authority of federal regulators to regulate incentive-based compensation at a wide variety of financial firms.

### Shareholder Votes on Executive Compensation

The Act requires public companies to provide their shareholders periodically with a non-binding vote ("say-on-pay") on the compensation of their executives, as well as on "golden parachute" severance arrangements in connection with mergers and other similar transactions.

#### Periodic Vote on Overall Compensation of Executives

The Act gives shareholders of public companies an opportunity to express, in a non-binding vote, their views on the compensation paid to the company's executives. Specifically, public companies will now be required to provide their shareholders, at least once every three years, with a non-binding

vote on the compensation of their executives at a meeting of shareholders for which the SEC's proxy solicitation rules require the inclusion of compensation disclosure. The vote will be based on the compensation paid to the company's "named executive officers" as disclosed under Item 402 of Regulation S-K, which includes the compensation committee report, compensation discussion and analysis, compensation tables and related disclosures.[1] While it is expected that most companies will hold such votes as part of a regular annual meeting, the Act permits such votes to be held at special meetings for which compensation disclosures are required in the proxy materials.

The new advisory shareholder vote on executive compensation will first be required at the first shareholder meeting occurring after the six-month anniversary of the Act's enactment, which likely means the new requirement will be in place for the 2011 spring proxy season. At that meeting, in addition to providing shareholders with an advisory vote on the compensation of executives, companies must also ask shareholders to cast a non-binding vote on whether the company should hold shareholder advisory votes on executive compensation every year or every two or three years.[2] Subject to any direction the SEC may provide on this subject, companies could, in their soliciting material for such proposals, express a preference for an annual, biennial or triennial approach and explain their rationale for recommending that their shareholders vote for a particular approach. Companies with multi-year incentive compensation plans may be better positioned to recommend a biennial or triennial say-on-pay vote than those with only annual incentive plans.

The Act states that both of the shareholder votes, *i.e.*, on executive compensation and on the frequency of its consideration by shareholders, are not binding on the company or its board of directors and may not be construed as overruling any decision of the company or its board of directors. Further, these shareholder votes may not be construed to create or imply any change to the fiduciary duties, or to create or imply any additional fiduciary duties, of the company or its board of directors. The legislation also states that the shareholder votes may not be construed to restrict or limit the ability of shareholders to make proposals related to executive compensation for inclusion in the company's proxy materials.

The Act's say-on-pay provisions are self-executing and do not, by their terms, require the SEC to adopt any implementing rules. It would not be surprising, however, for the SEC to adopt rules addressing this new requirement, especially in light of the SEC's rules implementing the requirement under the Emergency Economic Stabilization Act of 2008 for recipients of financial assistance under the Troubled Asset Relief Program to provide their shareholders with a non-binding say-on-pay vote.[3] Among other things, the SEC may wish to clarify, through rulemaking or interpretation, whether a company's inclusion of a say-on-pay proposal triggers the need to file a preliminary proxy statement and any disclosure that should accompany such proposal. The Act also authorizes the SEC to exempt an issuer or class of issuers from the say-on-pay shareholder vote requirements, and specifically mentions the potentially disproportionate burden of the requirement on small companies.

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[1] The "named executive officers" are the company's principal executive officer, principal financial officer, and the three other most highly paid executive officers during the most recent fiscal year. Although Rep. Barney Frank at one point suggested broadening the say-on-pay vote to cover compensation paid to a larger group of employees, this idea did not make it into the legislation. *See* Press Release, "Frank Announces Hearing on Compensation," House Committee on Financial Services, Jan. 13, 2010.

[2] Thereafter, shareholders must be asked at least once every six years whether they wish to have an annual, biennial or triennial advisory vote on executive compensation.

[3] *See* Rel. No. 34-61335 (Jan. 12, 2010).

### Vote on Golden Parachutes

Public companies will also be required, in connection with proxy or consent solicitations relating to merger, acquisition or similar transactions, to provide their shareholders with specific disclosures about, and a separate non-binding vote on, any "golden parachute" compensation arrangements. These include any agreements or understandings with any named executive officers of the company (or the acquiring company) concerning any type of compensation (whether present, deferred or contingent) that is based on or related to the merger or acquisition transaction. The disclosure regarding golden parachute arrangements will have to be provided in clear and simple form under rules to be promulgated by the SEC.

The new advisory shareholder vote on golden parachutes, as well as the new proxy disclosures regarding such arrangements, will first be required in connection with any shareholder meeting called to vote on a merger, acquisition or similar transaction occurring after the six-month anniversary of the Act's enactment. The SEC must adopt rules specifying the required disclosures about golden parachutes within the same time frame.

If the company's golden parachute arrangements have previously been subject to a vote of shareholders as part of the periodic shareholder vote on executive compensation as described above, no separate shareholder vote on the golden parachute arrangements is required in connection with a shareholder vote on the merger or acquisition transaction. Like the annual say-on-pay vote on executive compensation described above, the shareholder vote on golden parachute arrangements will not be binding on the company or its board of directors and may not be construed as overruling any decision of the company or its board of directors. In this regard, shareholder approval of a merger agreement should not be affected by a negative shareholder advisory vote on the golden parachute arrangements for the company's executives at the same meeting.

## Shareholder Access To the Proxy

The Act implements a number of new corporate governance-related provisions that will give shareholders the opportunity to have greater influence over their company's affairs.[4] Most significantly, the Act amends Section 14 of the Securities Exchange Act of 1934 (the Exchange Act) to make it clear that the SEC has authority to adopt rules requiring public companies to include board nominees submitted by shareholders in the company's proxy materials.[5] The Act also explicitly permits the SEC to exempt smaller public companies from any such shareholder access rules. The SEC, of course, already has a pending rule proposal to give shareholders the opportunity to nominate directors in their company's proxy materials.[6] Under the SEC's proposal, a shareholder meeting specified ownership thresholds (1% for a large accelerated filer, 3% for an accelerated filer, 5% for all others) would be entitled to require the company to include its nominee(s) in the company's proxy

[4] It should be noted that the Senate-approved financial regulatory reform bill would have called for even greater insertion by the federal government into the internal governance of corporations. The Senate bill would have required all listed companies to adopt a majority voting standard in uncontested elections of directors. This provision was dropped during the conference negotiations.

[5] During the House-Senate conference process, a number of proposals were made by Senate conferees that would have required the SEC's rules to limit the proxy access right to shareholders owning a specified amount of a company's shares and/or for a specified period of time. After lengthy deliberations, these proposals were ultimately dropped. It will be interesting to see if this debate influences in any way the SEC's current rulemaking in this area. See f.n. 6 below.

[6] Rel. No. 34-60089 (Jun. 10, 2009).

materials, as long as the shareholder has the right to nominate directors under applicable state law and the company's governing documents. Such shareholders would be entitled to nominate the greater of one nominee or 25% of the number of board seats up for election.

## Role of the Compensation Committee

The Act strengthens the independence and authority of Board compensation committees, presumably in an effort to enhance Board oversight of executive compensation. Specifically, companies with securities listed on national securities exchanges or national securities associations will be subject to new required listing standards that their compensation committees be comprised entirely of independent directors.[7] In defining the term "independence" for purposes of these listing standards, the national securities exchanges must consider relevant factors, including (i) the source of compensation of a member of the board of directors, including any consulting, advisory, or other compensatory fee paid by the company to such director, and (ii) whether a director is affiliated with the company, a subsidiary, or an affiliate of a subsidiary.[8] The securities exchanges would have the authority to exempt a particular relationship from the independence requirements, taking into account the size of a company and any other relevant factors.

The Act encourages compensation committees to use outside consultants and advisers that are independent, presumably on the basis that consultants will give better advice about compensating the company's executives if they are not unduly beholden to the same executives as a result of providing other services to the company. Through the required new listing standards, the Act confirms that the compensation committee has the authority, in its sole discretion, to appoint, compensate and oversee the work of compensation consultants, independent legal counsel and other advisors. Although the Act does not mandate, *per se*, the use of independent consultants, compensation committees will be required to consider a number of specific factors, to be identified by the SEC through rulemaking, before selecting a compensation consultant, legal counsel, or other adviser to the committee. The factors to be identified by the SEC would be factors that might affect the independence of a compensation consultant, legal counsel or other adviser, including providing services to the company outside the mandate of the compensation committee.[9]

The new listing standards relating to compensation committees will not apply to "controlled companies," which are listed companies of which more than 50 percent of the outstanding voting power is held by an individual, a group, or another issuer of securities. In addition, the Act provides authority for national securities exchanges to exempt a category of issuers from the requirements of the new listing standards, particularly taking into account the potential impact of such requirements on smaller reporting companies.

Although the Act makes clear that compensation committees have the authority to retain independent legal counsel, the Act does not specifically require that compensation committees use

[7] The New York Stock Exchange and the NASDAQ Stock Market already require that compensation committees of public companies be comprised entirely of directors who are independent under the respective independence criteria of these exchanges.

[8] This is, effectively, a corollary to Section 10A of the Exchange Act, which sets independence requirements for members of audit committees of listed public companies and was added to the Exchange Act by the Sarbanes-Oxley Act of 2002.

[9] The Act states that the factors to be promulgated by the SEC must be competitively neutral among categories of consultants, legal counsel and other advisers and must preserve the ability of compensation committees to retain the services of members of any such category.

only independent legal counsel. However, the committee's decision to retain legal counsel must be considered in light of the "independence" factors identified by the SEC, which in turn will, undoubtedly, create a strong presumption that counsel retained by the compensation committee should be independent. Whether a particular relationship or the provision of particular services to the company precludes legal counsel from being deemed independent for purposes of serving the compensation committee will raise a range of challenging issues for the SEC to sort out in the implementing rules. Finally, nothing in the Act appears to prohibit the compensation committee from receiving advice from counsel retained by the company if it so chooses.

## Recovery of Erroneously Awarded Compensation

Although many public companies have already voluntarily implemented so-called "claw back" policies addressing the recovery of compensation when it is later shown that the compensation was based on erroneous financial results, the Act will require all listed companies to adopt such a policy. Specifically, companies with securities listed on national securities exchanges or national securities associations will be subject to required new listing standards requiring them to implement "claw back" policies.

Under this requirement, the company's claw back policy must provide that, if the company is required to restate its financial statements due to the company's material noncompliance with any financial reporting requirement, the company will recover from any current or former executive officer who received incentive-based compensation during the three-year period preceding the date of the restatement, based on the erroneous data, in excess of what would have been paid to the officer under the restatement. Companies must also disclose their policy on incentive-based compensation that is based on financial performance required to be reported under the securities laws.

The scope of the claw back policy required to be adopted by listed companies is broader than the scope of the SEC's recovery authority under Section 304 of the Sarbanes-Oxley Act of 2002. In that sense, the claw back provisions of the Act represent an effort to encourage companies to police themselves and thereby augment the SEC's efforts. Section 304 of Sarbanes-Oxley, for instance, only permits the recovery of compensation in circumstances where there has been "misconduct" (versus "material noncompliance" in the Act), which has limited the utility of Section 304. [10] Further, Section 304 of Sarbanes-Oxley may only be used to recover compensation from a company's chief executive officer or chief financial officer, whereas the Act's claw back provision would permit recovery from any current or former executive officer.

## New Required Compensation and Governance Disclosures

The Act includes a number of new compensation and governance disclosure requirements.

### Comparison of Employee Median Compensation and CEO Compensation

The Act requires the SEC to adopt a rule requiring companies to disclose, in a variety of filings with the SEC, (i) the median of annual total compensation of all employees of the company other than the CEO, (ii) the CEO's annual total compensation, and (iii) the ratio of the amounts shown in clauses (i) and (ii). According to the Act, this information would be required to be shown in registration statements filed under the Securities Act of 1933 or Exchange Act, annual and other (quarterly)

[10] Recently, however, the SEC did prevail for the first time in a Section 304 action where the chief executive officer was not alleged to have committed any misconduct in his individual capacity. *See* Lit. Rel. No. 21543 (Jun. 2, 2010) and SEC v. Walden O'Dell (Civil Action No. 1:10-CV-00909 (D.D.C.).

reports under Sections 13 and 15(d) of the Exchange Act, going-private transaction statements, tender offer statements and proxy and information statements.

### Relationship Between Compensation and Performance

The Act requires public companies to provide in their annual proxy statements, in accordance with rules to be adopted by the SEC, a clear description of any compensation required to be disclosed under Item 402 of Regulation S-K, including information showing the relationship between compensation paid and the company's financial performance, taking into account any change in the value of the company's stock and dividends and distributions. The information called for by this provision may be included by means of a graphic representation. This new statutory requirement arguably already has been addressed by the SEC through, for example, the Compensation Discussion and Analysis disclosure requirement and the various tabular disclosures called for by Item 402 of Regulation S-K. The one new area of disclosure that likely will flow from this provision will involve the relationship of executive pay to financial performance, almost certainly to be the subject of a detailed, and perhaps controversial, SEC rulemaking.

### Additional Disclosures About Use of Compensation Consultants

Companies will be required to disclose in their annual proxy statements (beginning one year after the date of the Act's adoption) whether the compensation committee retained or obtained the advice of a compensation consultant, and whether the consultant's work has raised any conflict of interest. If any such conflict of interest arose, the company must disclose the nature of the conflict and how it is being addressed. This disclosure requirement will be implemented through rules to be adopted by the SEC within one year of the enactment of the Act.

### Disclosure of Institutional Investment Managers' Say-on-Pay Votes

The Act requires institutional investment managers subject to Section 13(f) of the Exchange Act to report, at least annually, how they voted on any shareholder votes on executive compensation or golden parachute arrangements.[11] This new disclosure requirement goes beyond the very limited information currently required to be disclosed by institutional investment managers regarding the securities they hold. The practical effect of this new requirement is likely to be somewhat muted by virtue of the new reports presumably being required to be filed sometime after a shareholder meeting, not beforehand.

### Chairman and CEO Leadership Structures

The Act requires the SEC to adopt rules requiring public companies to disclose in their annual proxy statements the reasons why the company has chosen either (i) the same person to serve as chairman of the board of directors and chief executive officer, or (ii) different individuals to serve in those positions. The SEC recently adopted a rule calling for substantially the same disclosure, so it will be interesting to see if this provision of the Act prompts further requirements in this area.[12]

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[11] Section 13(f) of the Exchange Act applies to institutional investment managers that exercise investment discretion with respect to accounts holding equity securities registered under Section 12 of the Exchange Act having an aggregate fair market value of at least $100 million. These institutional investment managers must file quarterly reports on Form 13F with the SEC to report basic data about the securities they hold.

[12] *See* Item 407(h) of Regulation S-K.

### Disclosure of Employee and Director Hedging

The Act requires public companies to disclose in their annual proxy statements, in accordance with rules to be adopted by the SEC, whether employees or directors are permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) designed to hedge or offset any decrease in the market value of the company's equity securities, whether such securities are granted to the employee or director as part of such person's compensation or held by such employee or director. Although some companies have already addressed this issue in a company policy, at least with respect to executives and directors, all public companies will need to follow subsequent SEC rulemaking to assess adopting new or amending current policies to address the issue.

## Broker Voting

The Act requires national securities exchanges to amend their rules to prohibit members of the exchange (*i.e.*, brokers) from granting a proxy to vote shares on specified proposals unless the beneficial owner of the shares has given the broker instructions on how to vote. The proposals covered by this prohibition include elections of directors, executive compensation proposals (presumably including any say-on-pay vote on the company's executive compensation), or any other "significant matter" as determined by the SEC through rulemaking. This provision of the Act will make it harder for management proposals on executive compensation (and other "significant matters" as determined by the SEC) to prevail, since brokers will not be able to vote shares held in street name unless the beneficial owner has given the broker instructions on how to vote.[13]

## New Powers to Regulate Compensation at Many Financial Firms

The Act contains two separate provisions giving federal banking regulators and the SEC new powers to regulate compensation arrangements at a wide variety of financial firms.

### Regulation of Incentive-Based Compensation Arrangements

Section 956 of the Act gives new authority to federal banking regulators and the SEC to examine, and impose restrictions on, incentive-based compensation arrangements at a range of financial firms. Under this provision, a "covered financial institution" will be required to disclose to the appropriate regulator the structures of all incentive-based compensation arrangements to enable the regulator to determine whether such structures (i) provide any executive officer, employee, director or principal shareholder with *excessive* compensation, fees or benefits, or (ii) could lead to material financial loss to the institution.

More significantly, the Act requires the federal regulators jointly to issue rules or guidelines prohibiting any such incentive-based arrangement, or any feature of such arrangement, that the regulators determine encourage inappropriate risks by covered financial institutions by providing any executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or that could lead to material financial loss to the institution. It is important to note that this authority is not limited to compensation arrangements for executives, which has historically been the focus of the SEC's disclosure rules. Rather, this new authority covers incentive-based arrangements that extend to all employees, as well as incentive-based arrangements with principal shareholders.

[13] In 2009, the NYSE's Rule 452 was amended to eliminate broker discretionary voting in elections of directors (except for registered investment companies).

This authority to examine and restrict incentive-based compensation applies to any "covered financial institution," a term which includes banks, thrifts and their holding companies, as well as credit unions, registered broker-dealers, investment advisers (including those not registered with the SEC), Fannie Mae, Freddie Mac and "any other financial institution" that the federal regulators jointly determine should be treated as such. However, any institution with assets below $1 billion is excluded.

In determining whether incentive-based compensation arrangements encourage inappropriate risks, the federal regulators are instructed to follow standards comparable to the standards established under the Federal Deposit Insurance Act for insured depository institutions. These standards deem compensation to be excessive if the amounts paid are unreasonable or disproportionate to the services performed, in light of a number of specific factors including, among other things, the combined value of all cash and non-cash benefits provided, the compensation history of the individual and other individuals with comparable expertise at the institution, the financial condition of the institution, and comparable compensation practices at comparable institutions.

### Compensation Schemes of Brokers, Dealers and Investment Advisers

Section 913 of the Act authorizes the SEC to examine, and where appropriate, issue rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the SEC deems contrary to the public interest and the protection of investors. On its face, this broad language seems to give authority to the SEC to regulate both the arrangements by which clients compensate their brokers, dealers and investment advisers, as well as the internal compensation arrangements for such entities' executives and/or employees. While the impetus for this provision might have been a concern about full disclosure of fees charged to retail brokerage clients, the broad sweep of the language would potentially allow the SEC to impose restrictions on contractual arrangements by which private equity and hedge fund managers are compensated in their roles as investment advisers.

## Key Issues for Rulemaking Phase

The Act leaves many important issues to be fleshed out in rulemaking proceedings at the SEC and listing standard modification proceedings by national securities exchanges. Among the key issues for the rulemaking phase are the following:

- The further evolution of the SEC's pending rule proposal addressing shareholder access to the proxy.
- Procedural and/or disclosure requirements pertaining to the new say-on-pay requirements, including the content of new disclosures regarding golden parachute arrangements.
- Factors relating to the independence of compensation consultants, legal counsel and other advisers to compensation committees, which factors are to be considered by the compensation committee before retaining such advisers.
- The scope of additional disclosure requirements showing the relationship between compensation paid and the company's financial performance, as well as regarding the CEO's compensation as it relates to median compensation for all employees.

- The scope of any other "significant matters" as to which brokers may not vote shares held in street name without instructions from the beneficial owners of such shares and how this change may affect other proxy system enhancements the SEC may initiate.[14]
- The scope of any SEC rules restricting compensation arrangements at brokers, dealers and investment advisers.

## What You Can Do

Public companies potentially affected by the Act may want to consider taking a number of steps, including:

- Keeping abreast of key developments in the rulemaking phase in the ensuing months so that they can fully understand the implications of proposed rules for their businesses and evaluate what efforts, if any, are being made by other firms/industry groups to participate in, and possibly shape, the rulemaking process.
- Developing realistic strategies to respond to the proposed rules — and ensuring that such strategies are effectively implemented. This would include considering how most effectively to communicate firm and industry views on proposed rules to SEC commissioners, the federal banking regulators and their respective staffs (for example, individually, through *ad hoc* groups or through trade associations).
- Separately, developing compliance action plans for expected new rules, including internal training and education, and, where appropriate, briefing of senior officers and relevant board members.
- Mapping out possible amendments to the charters of the Board's compensation and/or nominating committees to address new requirements under the Act and impending SEC rules.

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If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:


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|---|---|---|
| David Engvall | 202.662.5307 | dengvall@cov.com |
| David Martin | 202.662.5128 | dmartin@cov.com |
| Bruce Bennett | 212.841.1060 | bbennett@cov.com |
| Bruce Deming | 415.591.7051 | bdeming@cov.com |
| Peter Laveran-Stiebar | +44.(0)20.7067.2021 | plaveran@cov.com |




[14] The SEC voted on July 14, 2010 to issue a concept release on the mechanics of proxy voting and related issues, sometimes referred to as the "proxy plumbing" project. *See* Rel. No. 34-62495 (Jul. 14, 2010).

ANNEX A

## Agency Rulemakings
## Executive Compensation and Corporate Governance

| Section of Act | Subject of Rulemaking | Agency | Deadline |
|---|---|---|---|
| 951 | Disclosure about "golden parachute" arrangements | SEC | Six months after enactment of Act |
| 971 | Shareholder access to the proxy | SEC | No deadline specified, but SEC rulemaking pending |
| 952 | Rules directing national securities exchanges and national securities associations to adopt listing standards regarding independence of compensation committees and retention by compensation committees of consultants, legal counsel and other advisers | SEC | 360 days after enactment of Act |
| 954 | Rules directing national securities exchanges and national securities associations to adopt listing standards regarding adoption of "claw back" policies | SEC | No deadline specified |
| 953 | Disclosure of median annual total compensation of all employees and CEO's annual total compensation<br><br>Disclosure showing relationship between compensation paid and company's financial performance (which may be by graph) | SEC | No deadline specified |
| 952 | Disclosure of whether the compensation committee has retained a compensation consultant and regarding any conflicts of interest raised by the work of such consultant | SEC | One year after enactment of Act |
| 972 | Disclosures about Board chairman and CEO structures | SEC | 180 days after enactment of Act |
| 955 | Disclosures about company's policies on hedging by employees and directors | SEC | No deadline specified |
| 957 | Rulemaking to identify "significant matters" as to which brokers may not grant a proxy to vote shares without instruction from beneficial owner | SEC | No deadline specified |

| Section of Act | Subject of Rulemaking | Agency | Deadline |
|---|---|---|---|
| 956 | Rules or guidelines prohibiting incentive-based compensation arrangements that encourage inappropriate risks by covered financial institutions (including brokers, dealers and investment advisers) | Federal banking regulators<br><br>SEC | Nine months after enactment of Act |
| 913 | Rules regarding "compensation schemes" at brokers, dealers and investment advisers | SEC | No deadline specified |