



EMPLOYEE BENEFITS & SECURITIES INDUSTRY PRACTICE

ALERT

DODD-FRANK AND EXECUTIVE COMPENSATION: WHAT'S A PUBLIC COMPANY AND ITS COMPENSATION COMMITTEE TO DO?

By Adam B. Cantor

On July 21, 2010, President Obama signed into law a sweeping financial reform bill, known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The new law ushers in fundamental changes in executive compensation disclosure, compensation committee independence, shareholder voting rights and clawbacks. The following summarizes the key elements of these changes.¹ **A summary of key compliance issues and tips appears at the end of this alert.** Dodd-Frank generally applies to proxy or consent solicitations occurring after January 21, 2011.

Executive Compensation Disclosure

- **Pay vs. Performance** – The SEC is to promulgate rules under which a public company (technically, the issuer of the securities) must disclose, in any proxy or consent material for an annual meeting of the shareholders, “a clear description of any compensation required to be disclosed [under Item 402 of Regulation S-K] . . . , including information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions.”
- **Rank and File vs. CEO Pay** – The SEC is to amend Item 402 to require disclosure of:
 - The median (that means 50 percent above, 50 percent below, not the average) of the annual total compensation of all employees of the issuer, other than the CEO (the Rank and File Median);

- The annual total compensation of the CEO (CEO Compensation); and
- The ratio of the Rank and File Median to CEO Compensation (the Compensation Ratio).

Compensation Committee Independence

- **Condition of Being Listed** – With certain exceptions (e.g., issuers that are majority owned subsidiaries, companies in bankruptcy, limited partnerships and certain mutual funds and foreign private issuers), a failure to comply with the Compensation Committee independence requirements of Dodd-Frank can result in the issuer’s securities being de-listed. The SEC is directed to issue, no later than July 16, 2011, rules prohibiting the listing of any security of an issuer that does not comply with the independence requirements. Such rules will provide an issuer a “reasonable” opportunity to “cure” any such defect before a de-listing occurs.
- **Compensation Committee Member Independence** – Each member must be a member of the board of directors and, as determined by the applicable national securities exchange or association, also be “independent.” The SEC is to promulgate rules under which, in determining independence, the national securities exchanges and associations must consider certain (non-exclusive) factors:

¹ The provisions of Dodd-Frank applicable to covered financial institutions, investment managers and broker-dealers and relating to corporate governance, such as proxy access (shareholders’ rights to nominate candidates for director) and the CEO/Board Chairperson leadership structure, will be addressed in future alerts.

- Source of compensation (e.g., consulting, advisory and other compensatory fees); and
- Affiliation with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

The applicable exchange or association may exempt a particular relationship from the Compensation Committee independence requirements, “as the national securities exchange or national securities association determines is appropriate, taking into consideration the size of an issuer and any other relevant factors.”

• **Compensation Committee Authority Relating to Compensation Consultants, Legal Counsel and Other Advisors** – Dodd-Frank empowers the Compensation Committee, in its sole discretion, to retain or obtain the advice of a compensation consultant, legal counsel or other advisor. If so retained, the Compensation Committee bears direct responsibility for the appointment, compensation and oversight of the work of the compensation consultant, legal counsel or other advisor. The Compensation Committee need not follow the advice or recommendations of the compensation consultant, legal counsel or other advisor. However, in any proxy or consent solicitation for an annual meeting of the shareholders occurring on or after July 21, 2011, each issuer must disclose, with respect to any compensation consultant, whether:

- The Compensation Committee retained or obtained the advice of a compensation consultant; and
- The work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

• **Issuer Funding of Compensation Consultants, Legal Counsel and Other Advisors** – Dodd-Frank requires the issuer to provide for “appropriate funding,” as determined by the Compensation Committee, for the payment of “reasonable compensation” to a compensation consultant, independent legal counsel or any other advisor to the Compensation Committee.

• **Independence of Compensation Consultants and Other Compensation Committee Advisors** – The SEC is to identify factors that affect the independence of a compensation consultant, legal counsel or other advisor to a Compensation

Committee. Dodd-Frank mandates that such factors be “competitively neutral” among categories of consultants, legal counsel or other advisors and include:

- The provision of other services to the issuer by the person who employs the compensation consultant, legal counsel or other advisor;
- The amount of fees received from the issuer by the person who employs the compensation consultant, legal counsel, or other advisor, as a percentage of the total revenue of the person who employs the compensation consultant, legal counsel or other advisor;
- The policies and procedures of the person who employs the compensation consultant, legal counsel or other advisor that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation consultant, legal counsel, or other advisor with a member of the Compensation Committee; and
- Any stock of the issuer owned by the compensation consultant, legal counsel or other advisor.

Shareholder Voting Rights

• **Non-Binding Votes on Executive Compensation** – Not less frequently than once every three years, a proxy or consent or authorization for an annual or other meeting must include a separate resolution subject to shareholder vote to approve the compensation of executives, as disclosed pursuant to Item 402 of Regulation S-K. To implement this rule, not less frequently than once every six years, a proxy or consent or authorization for an annual or other meeting must include a separate resolution subject to shareholder vote to determine whether votes on executive compensation shall be required every one, two or three years. The proxy or consent or authorization for the first annual or other meeting occurring after January 21, 2011, must include these two resolutions. Votes on executive compensation are not required to be binding on the issuer.

• **Non-Binding Votes on Golden Parachute Payments** – In any proxy or consent material for a meeting of the shareholders occurring after January 21, 2011, at which shareholders are asked to approve

an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets of the issuer, the material must include disclosure of any change in control or similar agreements with executive officers of the issuer (including the amount of payments that potentially could be made under such agreements). Any proxy or consent or authorization relating to such agreements and related “golden parachute” payments must include a separate resolution subject to shareholder vote to approve such agreements and payments. These votes are not required to be binding on the issuer.

The SEC may exempt an issuer or a class of issuers from these requirements, with the Congressional mandate being to take into account, “among other considerations, whether the requirements . . . disproportionately burden small issuers.”

Clawbacks

- **Condition of Being Listed** – A failure to comply with the clawback requirements of Dodd-Frank can result in the issuer’s securities being de-listed. The SEC is directed to issue interpretive regulations.
- **No Fault Clawback Rule** – Each issuer must develop and implement a policy providing:
 - For the disclosure of the policy of the issuer on “incentive-based compensation” that is based upon “financial information” required to be reported under the federal securities laws; and
 - That, in the event the issuer is required to prepare an accounting restatement due to the “material noncompliance” of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received “incentive-based compensation” (including stock options awarded as compensation) during the three-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, “in excess of what would have been paid to the executive officer under the accounting restatement.”

Key Compliance Issues and Tips

Executive Compensation Disclosure

1. **Forward-Looking Statements** – Beware of “forward-looking statements” with respect to pay vs. performance. (Multi-year bonus programs should be reviewed carefully.)
2. **Nature of Compensation** – Is it possible to “relate” executive compensation to performance other than through a grant of equity-based compensation?
3. **Compensation Ratio** – What’s the appropriate Compensation Ratio? Too “low,” (meaning that the CEO Compensation is too “high”) and shareholder revolt and headline risk may ensue. Too “high,” (meaning the CEO Compensation is too “low”) and the CEO may resign. Can the Compensation Ratio be “gamed?”
4. **Components of Compensation** – Dodd-Frank refers to Item 402(c)(2)(x), as in effect on July 20, 2010, for the definition of “total compensation.” This Item, in turn, refers to compensation required to be disclosed under the Summary Compensation Table. Many issuers have had difficulty computing the amounts to be disclosed under the Summary Compensation Table for their named executive officers (NEOs) - expanding the computational requirement to the rank and file will broaden greatly the resources required to complete the proxy disclosure properly. (An NEO includes each person serving at any time during the last completed fiscal year as the principal executive officer (PEO), each person serving at any time during the last completed fiscal year as principal financial officer (PFO), the three most highly compensated executive officers other than the PEO or PFO serving as executive officers at the end of the last completed fiscal year and up to two other persons whose compensation would have put them in the top three but for the fact that they were not executive officers at the end of the last completed fiscal year.) To this point, Item 402, as amended by the SEC in December 2009, already requires disclosure, with respect to all employees, “to the extent that risks arising from a company’s compensation policies and practices are reasonably

likely to have a material adverse effect on the company . . . " This disclosure relates to the issuer's risk management policies and practices.

Compensation Committee Independence

1. **Composition of Committee** – Is the Compensation Committee truly independent in composition? In addition to Dodd-Frank, compliance with the “independence” requirements of the applicable stock exchange (to the extent such requirements exceed those required under Dodd-Frank), Section 162(m) of the Internal Revenue Code, the accounting rules and institutional shareholder organizations might be necessary. Are there circumstances in which it would make sense for an issuer to wait for the SEC to issue its “de-listing” regulations before developing its “independence policies?” What constitutes a “reasonable” opportunity to “cure?”

2. **Compensation Consultant, et al.** – How “independent” is the Compensation Committee’s compensation consultant? A compensation consultant employed by management almost certainly cannot satisfy Dodd-Frank’s independence requirements. Each engagement letter with a compensation consultant should be reviewed for compliance with the independence requirements. New engagement letters between the Compensation Committee and the compensation consultant should be drafted. These suggestions also apply to legal counsel and other advisors retained by the Compensation Committee. Any SEC regulations in this regard will need to incorporate the December 16, 2009, Final Rule on proxy disclosure with respect to disclosure of fees paid to compensation consultants.

3. **Attorney-Client Privilege** – Be careful about a waiver of the attorney-client privilege. If legal counsel represents the Compensation Committee and the issuer, this can be a tricky issue to navigate.

4. **Conflict Resolution Policies and Procedures** – Request conflict resolution policies and procedures from any compensation consultant, legal counsel or other advisor to be retained by the Compensation Committee.

5. **Budget** – Negotiate a reasonable budget with the

issuer. This can be a source of contention, so start early.

Shareholder Voting Rights

1. **Non-Binding Votes** – Is a non-binding vote realistic? “Say on pay” has been a hot button executive compensation issue for years, and, even before the enactment of Dodd-Frank, had gained tremendous momentum among institutional investors.

2. **Beware of the Institutional Investor** – Not adhering to shareholder votes on executive compensation, especially on parachute payments (or approving gross-ups for parachute payment excise taxes), almost certainly would trouble institutional investors.

Clawbacks

1. **No Fault** – The clawback rule does not require any fault on the part of the executive officer. (In contrast, the Sarbanes-Oxley clawback rules generally require misconduct.) All that is needed is a required accounting restatement due to “material noncompliance” of the issuer and the payment of excess “incentive-based compensation.”

2. **Scope of Coverage** – Does the clawback rule apply to any executive officer of the issuer, or only to an executive officer who had “responsibility” for the financial information that was erroneously reported?

3. **Material Noncompliance** – What does “material noncompliance” mean? Will the SEC issue a numerical threshold only, or will the test be both quantitative and qualitative in nature?

4. **Incentive-Based Compensation** – What does “incentive-based compensation” mean? Dodd-Frank includes, by way of example, “stock options awarded as compensation,” but does not define the term.

5. **Term Vesting to the Rescue?** – Ostensibly, “incentive-based compensation” does not include any compensation that is payable through the mere lapse of time (e.g., continued employment through a certain date). Should a company shift performance-based compensation to term-based compensation? Would the shareholders, especially the institutional shareholders, stand for such a shift?

6. **Financial Information** – What kind of “financial

information” would need to be restated in order for the clawback provisions to apply?

7. Enhanced Forfeiture Provisions – Consider enhanced forfeiture provisions. A clawback may be difficult to enforce, as, by definition, the compensation already has been paid. Imposing another condition on the payment of the compensation would mitigate the need for a clawback.

8. Clawback Policy – Get started on that clawback policy. Best practices would militate in favor of including all named executive officers, references to “material noncompliance” and “financial information” as defined by the SEC in regulations to be promulgated and “defining” “incentive-based compensation” to include all compensation that relates in any way to one or more individual or issuer performance metrics.

9. Legal Counsel, et al. – Engage legal counsel and other advisors, e.g., compensation consultants, as soon as possible, to assist in developing the clawback policy. Practically, an issuer will need to work with its Compensation Committee on the policy (but “independence” must be maintained).

10. Role of Accountant – Contact your accountant immediately. The accountant may have some thoughts regarding “material noncompliance” and “financial information” subject to the clawback rule.

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