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Corporate Governance and Executive Compensation Provisions of the Financial Reform Act

On July 15, 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) which President Obama is expected to sign into law this week. The Act was passed largely in response to the 2008 financial crisis with the goals of restoring stability within the financial system, increasing corporate transparency and accountability to shareholders, and providing new consumer protections. Towards the goal of greater accountability, the Act imposes new corporate governance and executive compensation rules on public companies. This e-alert summarizes the key provisions applicable to those areas. Future e-alerts will address other areas of the Act.

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Shareholder Advisory Votes on Executive Pay

The Act gives shareholders of any company subject to the SEC's proxy solicitation rules a nonbinding vote on executive compensation and on "golden parachute" arrangements with executives.

- **Say on Pay**. The vote on executive compensation must be held at least once every three years. Shareholders will vote at least once every six years as to how frequently to have the vote on executive compensation. The vote will cover the compensation of executive officers as disclosed pursuant to Item 402 of Regulation S-K, and as such will cover the compensation of the executive officers named in the Summary Compensation Table. The requirement for a nonbinding vote on executive compensation takes effect for the first annual or other meeting of shareholders occurring at least six months after the enactment of the Act, and that meeting must include both a nonbinding vote on executive compensation and a vote on whether subsequent nonbinding votes on executive compensation will occur every one, two or three years.
- **Golden Parachute Compensation.** The provision regarding "golden parachute" arrangements also takes effect six months after enactment of the Act. A proxy statement for any meeting of shareholders held to approve an acquisition, merger, consolidation or sale of substantially all of a public company's assets must include disclosure of the golden parachute arrangements and a separate nonbinding shareholder vote must be taken on the arrangements disclosed unless such arrangements have already been subject to a vote under the "say on pay" voting provision. The arrangements

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covered are defined broadly to include all compensation to executive officers that is based on or otherwise relates to the applicable transaction.
- **Smaller Companies**. The Act authorizes the SEC to exempt a company or class of companies from the advisory votes, and specifically notes that the SEC can consider whether the advisory vote requirements will disproportionately burden smaller companies.

Additional Compensation Disclosures – Pay for Performance and Internal Pay Equity

- **Pay for Performance**. The Act requires the SEC to adopt rules for disclosure in annual meeting proxy statements of executive compensation information that shows the relationship between a company's financial performance (taking into account changes in the value of its stock price and payment of dividends) and the compensation paid to its executives. The disclosure may include a graphic
- **Internal Pay Equity**. The SEC must also amend its compensation disclosure rules to require disclosure of (1) the median annual total compensation for all employees (except the CEO), (2) the annual total compensation of the CEO, and (3) the ratio of the two.

Compensation Committees

- **Independent Directors**. Although the national securities exchanges currently specify independence standards for compensation committee members, the Act requires the SEC to adopt rules creating minimum independence standards and to direct the national securities exchanges to prohibit the listing of a public company whose compensation committee members do not satisfy the SEC's standards. Listed companies not subject to the SEC's standards include controlled companies, foreign private issuers and companies in bankruptcy. The SEC has the authority to create additional exceptions based on any factors it determines is appropriate (including the size of a company).
- **Compensation Consultants and Other Advisers**. The SEC is directed to identify the factors which affect the independence of compensation consultants or other advisers to the compensation committee. The SEC is required to adopt rules directing the national securities exchanges to prohibit the listing of a public company which does not provide that (1) its compensation committee may only hire consultants and advisers after taking into account those factors identified by the SEC, (2) its compensation committee has sole discretion regarding whether to hire compensation consultants or advisers to assist the

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committee in setting executive pay, and (3) its compensation committee is directly responsible for overseeing the work of compensation consultants or advisers. The annual meeting proxy statement must include disclosure of whether a company retained or obtained the advice of a compensation consultant and whether the compensation consultant's work has raised any conflict of interest. Controlled companies are excluded from these requirements and the SEC has authority to create additional exceptions based on other factors, such as the size of a company.

Claw Back of Compensation Based on Inaccurate Information

The Act requires the SEC to direct the national securities exchanges to prohibit the listing of any public company which does not establish policies to recover compensation paid to current and former executive officers based on financial statements that must be restated due to material noncompliance of the company with financial reporting requirements under securities laws (including GAAP). The compensation subject to recovery includes any incentive-based compensation (including stock options) received during the three-year period preceding the restatement. Significantly, this compensation claw back policy goes beyond the existing Sarbanes-Oxley provision in that it must apply to all instances when financial statements are restated not just when financial statements are restated due to misconduct, covers all executive officers rather than only the CEO and CFO, and has a three-year look back rather than one year.

Proxy Access

The Act authorizes the SEC to create rules by which shareholders of a public company may nominate directors through the company's proxy materials. Notably, however, the SEC is permitted to exempt certain classes of companies, such as small companies, based on the additional burden placed on such companies. This provision should provide momentum for the SEC to complete its proposed rule on proxy access (see "Facilitating Shareholder Director Nominations," Securities Act Release No. 33-9046, June 10, 2009) and eliminate any question of whether the SEC has the statutory authority to adopt proxy access rules.

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Disclosure Regarding Individuals Serving as CEO and Chairman

Within 180 days after enactment of the Act, the SEC must issue rules requiring a public company to disclose in its annual proxy statement the reason why it has the same person or different individuals serving as chairman of the board of directors and chief executive officer of the company. The SEC adopted proxy disclosure rules in December 2009 that largely already incorporate this requirement.

Hedging Disclosure

The SEC must adopt rules requiring a public company to disclose in its annual proxy statement whether employees or members of the board of directors are permitted to hedge or offset a decrease in the market value of equity securities granted as compensation or otherwise held, directly or indirectly, by the employees or directors.

Voting by Brokers

NYSE Rule 452 currently governs the authority of a broker to vote securities in the broker's discretion in the absence of instructions from its customer who is the beneficial owner of the shares. Rule 452 allows such discretionary voting on "routine" matters. The NYSE amended this rule in January 2010 to specify that uncontested director elections are no longer a routine matter. The Act goes further and provides that the national securities exchanges may not permit broker discretionary voting with respect to director elections, executive compensation (presumably including say on pay), and any other significant matter, as determined by the SEC.

Financial Institutions

- **Disclosure of Incentive-Based Compensation Structures**. Within 9 months after enactment of the Act, the relevant federal regulators are directed to establish regulations requiring "covered financial institutions" with assets of $1 billion or more (including bank holding companies, registered broker-dealers, credit unions and investment advisers) to disclose the structure of any incentive-based compensations systems.
- **Compensation Structures that Encourage Excessive Risk Prohibited**. The

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compensation system disclosures will be used by regulators to determine whether a covered financial institution's compensation system provides excessive compensation to any individuals or could lead to a material financial loss of the financial institution. Federal regulators are directed to create regulations prohibiting any incentive-based compensation system that encourages "inappropriate risks" (as determined by regulators) by a covered financial institution that could cause a material financial loss or provides an individual with excessive compensation.

Smaller Company Exemption from Internal Control Audit

Since the Sarbanes-Oxley Act was adopted in 2002, the SEC has repeatedly delayed the application to companies that are not accelerated filers (generally companies with a public float of less than $75 million) of the requirement in Section 404(b) for an audit of internal control over financial reporting. The Act creates a permanent exemption from the requirements of Section 404(b) for non-accelerated filers. In addition, the SEC is directed to conduct a study of the burden of complying with Section 404(b) on companies with a market capitalization of between $75 million and $250 million.

Next Steps

Passage of the Act is only the first step. The SEC and other federal regulators must now issue regulations to enforce the general provisions of the Act. The regulations will establish the detailed rules that public companies must follow with respect to the executive compensation and corporate governance matters discussed above.

If you have any questions or concerns regarding the issues discussed in this e-alert, please contact your Reinhart attorney or an attorney with Reinhart's securities team.

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