
The Executive Compensation and Corporate Governance Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act

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Overview

- ▶ The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Obama on July 21, 2010
- ▶ The Act not only contains sweeping regulatory reforms for the financial services industry and new financial consumer protections, it contains a number of changes that will have a significant effect on executive compensation programs and practices:
 - Mandatory “Say on Pay” for executive compensation programs and change-in-control arrangements
 - Mandatory compensation recovery (“clawback”) policies for erroneously-received incentive compensation
 - Enhanced independence requirements for compensation committee members
 - Independence considerations in selecting committee advisers
 - Enhanced proxy statement disclosures on executive compensation
 - New corporate governance rules, including “proxy access,” Chairman/CEO structures, and broker voting of uninstructed shares

Effective Dates

- ▶ Implementation is likely to proceed in four stages:
 - The shareholder advisory vote (“Say on Pay”) provisions are effective for annual shareholder meetings occurring after January 21, 2011
 - Consequently, the SEC will likely complete any necessary rulemaking to meet this effective date
 - The compensation recovery (“clawback”) provision has drawn significant attention from investors and executive compensation critics
 - Consequently, the SEC will likely move quickly to complete the necessary rulemaking
 - The compensation committee independence and committee adviser independence provisions are effective upon completion of SEC rulemaking (which must take place by July 16, 2011) and subsequent rulemaking by the national securities exchanges
 - It’s possible that these rules may not be in place in time for the 2011 proxy season
 - The other compensation-related provisions (specifically, the executive compensation-related disclosure requirements) are effective upon completion of SEC and/or national securities exchange rulemaking, for which there is no specific deadline
 - Consequently, it is not clear whether these provisions will be in place in time for the 2011 proxy season

“Say on Pay”

- ▶ Advisory vote on executive compensation program
 - Vote based on proxy statement executive compensation disclosure
 - Vote is non-binding – doesn’t affect actual compensation decisions
 - In light of prohibition on broker voting of uninstructed shares in executive compensation matters, companies should take vote seriously

- ▶ Must also conduct separate shareholder vote on the frequency of the “Say on Pay” vote
 - Vote frequency (every 1, 2, or 3 years) determined by shareholders
 - Starting in 2011, must solicit input at least once every six years

- ▶ Effective Date:
 - “Say on Pay” vote required for meetings held after January 21, 2011
 - All companies are required to conduct a vote during the 2011 proxy season

“Say on Pay” – Action Items

- ▶ Address any lingering concerns about executive compensation program
 - Have investors or Board of Directors identified any problematic pay practice?
- ▶ Review current executive compensation disclosure to see whether it can be improved
 - Consider simplifying the Compensation Discussion and Analysis
- ▶ Become familiar with executive compensation policies of key shareholders and proxy advisory firms to identify “red flags” that may influence a “no” vote
 - Decide whether to “reach out” to these shareholders to address their possible concerns or make changes to program to avoid a negative vote recommendation from ISS
- ▶ Analyze shareholder base to determine whether absence of broker voting will have any impact on vote
 - If so, determine how to ensure an adequate vote

“Say on Change-in-Control Arrangements”

- ▶ Disclosure of change-in-control arrangements
 - Must describe all arrangements and disclose amounts that named executive officers will receive

- ▶ Advisory vote on change-in-control arrangements (merger proxies only)
 - Vote required to extent arrangements have not previously been subject to an advisory vote on executive compensation program
 - Vote is non-binding – doesn’t affect actual compensation decisions
 - In light of prohibition on broker voting of uninstructed shares in executive compensation matters, companies should take vote seriously

- ▶ Effective Date:
 - “Say on Change-in-Control Arrangements” votes required for meetings held after January 21, 2011

“Say on Change-in-Control Arrangements” – Action Items

- ▶ While vote is situational, companies should consider the following items when preparing for the “Say on Pay” vote for their overall executive compensation program
 - Make sure all change-in-control arrangements are identified – the definition of what’s covered as set forth in the provision is fairly broad
 - Consider enhancing disclosure of existing change-in-control arrangements in proxy statement for annual shareholders meeting (including a clear explanation of the rationale for the arrangement) so that there is no question that they are covered by the exception to the vote
 - Consider whether to expand disclosure in annual proxy statement to cover all executive officers – the disclosure and advisory vote only cover named executive officers, but it’s unclear whether NEOs is based on last year’s or the current year’s determinations

Compensation Recovery (“Clawback”) Policy

- ▶ Exchange-listed companies must adopt policy providing for:
 - Recovery of erroneously-paid incentive compensation (including stock options) from both current and former executive officers during the three-year period in the event of a financial restatement due to material noncompliance with any financial reporting requirement under the securities laws
 - Disclosure of this policy

- ▶ Effective Date:
 - Requires that SEC adopt rules directing national securities exchanges to prohibit listing of any company that does not comply with this provision, but does not specify a deadline for doing so
 - We expect the SEC will try to have rules in place for the 2011 proxy season

Compensation Recovery (“Clawback”) Policy – Action Items

- ▶ While many of the details about this policy will require SEC rulemaking, companies should consider the following items now:
 - If a company does not currently have a compensation recovery policy, it should decide whether the scope of the mandated policy is sufficient – for example, the triggering events may be too narrow – this may involve going beyond the scope of the new provision
 - If a company already has a compensation recovery policy, it needs to compare its policy against the specifics of the mandated policy to see if any changes or modifications will be necessary
 - Also, should review current outstanding compensation arrangements, including incentive compensation plans and employment agreements to determine whether any modifications are needed
 - Consider enhancing disclosure of compensation recovery policy, both in the Compensation Discussion and Analysis and in connection with the advisory vote on executive compensation – shareholders are likely to want to know how your policy stacks up against the mandated policy

Compensation Committee and Committee Adviser Independence

- ▶ The compensation committee of an exchange-listed company must be comprised of “independent” directors
 - The SEC is to develop a definition of “independence” that takes into consideration source of compensation paid to any committee member (including consulting and advisory fees) and whether committee member is an affiliate of the company, a subsidiary of the company, or an affiliate of a subsidiary of the company
- ▶ The compensation committee of an exchange-listed company may only select a compensation consultant, legal counsel, or other adviser after considering factors identified by the SEC that may affect the independence of such adviser
 - These factors must include (but are not limited to) the adviser provides other services to the company, the fees received from the company as a percentage of the adviser’s total revenue, the adviser’s policies for preventing a conflict of interest, any business or personal relationships, and whether the adviser owns stock in the company
- ▶ Effective Date:
 - July 16, 2011

Compensation Committee and Committee Adviser Independence – Action Items

- ▶ Compensation Committee independence
 - While a comprehensive review will have to wait until the SEC and the national stock exchanges complete their rulemaking, companies should consider the following items now:
 - Re-examine your compensation committee member relationships in light of the new standards
 - One item that could present problems for venture capital-backed companies is the prohibition on affiliates being independent
 - If you expect that you may not have enough independent committee members, consider increasing the size of the board of directors and recruiting new members

- ▶ Compensation adviser and legal counsel independence
 - Again, technical compliance will depend on the SEC and national stock exchange rules. Until then, companies should
 - evaluate their current compensation consultant relationship to identify any potential discussion points under the factors identified in the provision
 - Evaluate the role of outside legal counsel in working with and advising the compensation committee to identify any potential conflicts of interest
 - Determine whether to enhance disclosure about the use of compensation consultants and other advisers

Enhanced Executive Compensation Disclosure Requirements

- ▶ Disclosure of Pay Versus Performance
 - Public companies must disclose in their proxy statements the relationship between executive compensation actually paid and the company's financial performance (including dividends and distributions). This disclosure may be presented graphically

- ▶ Disclosure of CEO Pay Ratio
 - Public companies must disclose in any filing the median annual total compensation of all employees (excluding the CEO), the annual total compensation of the CEO, and the ratio of median employee annual total compensation and CEO total compensation

- ▶ Disclosure of Employee and Director Hedging
 - Public companies must disclose in their proxy statements whether employees or directors are permitted to hedge the risk associated with equity securities awarded as compensation or held by the employee or director

- ▶ Effective Date:
 - Effective upon completion of SEC rulemaking, which may not occur until sometime during 2011

Enhanced Executive Compensation Disclosure Requirements – Action Items

- ▶ Disclosure of Pay Versus Performance
 - Review past disclosures of incentive compensation arrangements and consider providing greater disclosure about compensation policies and alignment to financial performance
 - Add an executive summary to Compensation Discussion and Analysis that addresses this relationship
 - In the absence of SEC rules, consider presenting graphic disclosure showing the relationship between aggregate named executive officer compensation and corporate financial performance (for example, TSR) over an extended period of time (for example, five years)

- ▶ Disclosure of CEO Pay Ratio
 - While many aspects of provision are currently impractical, the concept is here to stay, so companies should consider the following items now:
 - Providing disclosure that focuses on the relative “internal pay equity” between the chief executive officers and the other named executive officers over a meaningful period of time
 - Addressing the subject of internal pay equity in the Compensation Discussion and Analysis

Enhanced Executive Compensation Disclosure Requirements – Action Items

- ▶ Disclosure of Employee and Director Hedging
 - Companies without an employee and director hedging policy should consider adopting a comprehensive “hedging” policy before the end of the year
 - Companies with an employee and/or director hedging policy should consider modifying the policy to tailor it to the scope to the new provision

Other Corporate Governance Reforms

- ▶ Proxy Access
 - Expressly authorizes the SEC to adopt proxy access rules
 - The SEC is expected to adopt final rules later this summer (perhaps in August)
- ▶ Broker Voting of Uninstructed Shares
 - Brokers are to be prohibited from voting uninstructed shares in uncontested director elections, on executive compensation matters (which includes “Say on Pay” votes) and any other significant matter as determined by the SEC
 - Provision became effective on July 22, 2010; expected to apply to fall votes as well as during 2011 proxy season
- ▶ Disclosure Regarding Board Chair and CEO Structures
 - Public companies must disclose in their proxy statements whether the same or different persons serve as chairman of the board and CEO and the reasons for the selected structure
 - Requirement parallels recent SEC disclosure requirement
 - SEC must adopt implementing rules by January 17, 2011
- ▶ Majority voting standard for election of directors was not adopted

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

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