



# Dodd-Frank: What Impact Will it Have On Compensation?

Linda E. Amuso, President, Radford

Christine McCarthy, Partner, Orrick

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# Dodd-Frank Wall Street Reform and Consumer Protection Act

## Today's Presentation

- ✦ Overview of the Dodd-Frank legislation
- ✦ Outline company implications
- ✦ Question and answer session



# Dodd-Frank Wall Street Reform and Consumer Protection Act

- ✦ Adopted July 21, 2010
- ✦ Includes sweeping new law related to corporate governance, executive compensation and disclosure
- ✦ Many of the substantive provisions require various regulatory agencies (e.g., the SEC) to adopt rules necessary to implement the new law
- ✦ In some cases, the regulatory agencies are authorized to exempt certain companies, including smaller reporting companies, from application of the new law
  - The law generally leaves it open to the regulatory agencies to determine whether and to what extent to offer exemptions



# Dodd-Frank Wall Street Reform and Consumer Protection Act

## Say On Pay

- ✦ Providing shareholders with a voice on executive compensation matters and a say on the frequency of that vote

## Say on Golden Parachutes

- ✦ Providing shareholders with a voice on change in control payments and structure

## Clawback Pay

- ✦ Expanding coverage for re-capturing incentive compensation (both cash and equity)

## Enhanced Disclosure

- ✦ Disclosure of pay for performance and pay relationships

## Committee Independence

- ✦ Independent membership and authority to engage independent advisors

## Broker Voting

- ✦ Prohibiting broker-dealer voting for election of Board, executive compensation and other matters unless explicitly instructed



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## Say on Pay

- ★ Non-binding advisory vote on executive compensation (CD&A, compensation tables and related narrative disclosure)
- ★ First say on pay vote and vote frequency must occur at the first annual meeting (or other meeting requiring compensation disclosure) occurring on or after **January 21, 2011**
- ★ Vote must not be less frequent than every 3 years
  - Shareholders entitled to a non-binding advisory vote at least once every 6 years on the frequency of say on pay vote (e.g., 1, 2 or every 3 years)
- ★ Institutional investors will be required to report how they vote on these matters
- ★ Both the say on pay vote and the vote on the frequency of the vote are non-binding advisory votes.
  - This means that companies are not required to follow the vote if they choose not to
  - However, as a practical matter, companies will likely be compelled to follow the advisory vote (if they do not follow the vote, it is likely that the shareholders will respond by voting against directors or other compensatory related items (e.g., stock plans))



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## Say on Golden Parachutes

- ★ Any proxy or consent soliciting the approval of the shareholders of an M&A transaction must include:
  - Disclosure of the terms of golden parachute payments to named executive officers in connection with an M&A transaction; and
  - A non-binding shareholder vote on the golden parachute payments (unless such payment have already been subject to a say on pay vote)
- ★ Applies to any meeting to approve transaction occurring on or after **January 21, 2011**
- ★ Institutional investors will be required to report how they vote on these matters



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## Clawback Provisions & Incentive-Based Compensation

- ✦ Any issuer that is required to restate financials **due to material noncompliance** of the issuer with any financial reporting requirement must recover from any **current or former executive officer**, the excess amount of any **incentive compensation** (including stock options) received during the **3-year period** preceding the date the issuer is required to prepare the restatement above what should have been received due to the erroneous data
  - This provision is broader than the current rules required by Sarbanes-Oxley
- ✦ The SEC must adopt rules requiring the national securities exchanges or associations to enact listing standards requiring issuers to disclose policies related to incentive-based compensation tied to financial information reported under the securities rules



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## New Compensation Disclosure

- ✦ The SEC must adopt rules requiring disclosure of:
  - The relationship between pay and company performance (including change in stock value and dividends or other distributions)
  - The median annual **total compensation** of **all employees** except the CEO, the annual total compensation of the CEO and the ratio of these two items
  - Whether any employee or director is permitted to engage in hedging transactions in company stock
  - The rationale for Board structure and leadership
    - > CEO as Board chair or non-CEO Board chair and the reasoning behind the structure



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## Independence of Compensation Committee Members

- ✦ SEC must require the national securities exchanges and associations to enact listing standard prohibiting the listing of any issuer that does not have an independent compensation committee
  - Certain companies, including companies in bankruptcy proceedings are exempt
- ✦ The SEC rules must require the exchanges and associations to consider certain factors in establishing these rules, including
  - The source of director compensation (consulting or other fees) and whether the directors are affiliated with the issuer or an affiliate of the issuer



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## Independence of Compensation Committee Advisors

- ✦ The compensation committee may, in its sole discretion, retain the advice of a compensation consultant, legal counsel or other advisors and shall be directly responsible for hiring, compensating and overseeing the work of such consultant
- ✦ Companies must provide appropriate funding to reasonably compensate such advisors, as determined by the compensation committee
- ✦ The SEC will be issuing guidance on the factors that should be considered in establishing the independence of advisors to avoid conflicts of interest
  - Definition is not extended to legal counsel
- ✦ Disclosure for meetings occurring on or after **July 21, 2011** must state whether the compensation committee retained a compensation consultant and if it raised any conflict of interest



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## Broker Discretionary Voting

- ✦ The national securities exchanges and associations must adopt listing standards prohibiting broker-dealers from voting any security for which they do not receive instructions with respect to the election of directors, executive compensation or other significant matters (to be determined by the SEC)
  - Note that the NYSE eliminated discretionary voting for uncontested director elections in 2009



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## New Regulations

## Implications

### Say On Pay

- ✦ Message to the Board and management on the level of and structure of executive compensation
- ✦ Expect to see increased disclosure/ narrative on the factors considered when setting executive compensation
- ✦ Expect to see an increase use of performance-based compensation to “justify” above market pay
- ✦ Expect to see pay philosophies move to the middle “median” unless there is a strong business reason to set pay above market levels
- ✦ Withhold votes for Compensation Committee members could increase
- ✦ Re-pricing provisions without shareholder approval likely to be eliminated

### Say On Golden Parachutes

- ✦ Expect companies to re-visit the amount of consideration provided both in the form of cash and equity and the rate of acceleration
- ✦ Expect gross-up provisions to be eliminated and replaced with best net after-tax benefit
- ✦ Analysis should be performed to examine walk-away value in the form of cash versus equity; shareholders likely to put pressure on companies where walk-away value is “high”
- ✦ Double trigger becomes the norm with tighter definitions



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## New Regulations

## Implications

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|---------------------|---|
| Clawback Pay        | <ul style="list-style-type: none"><li>✦ Companies with policies will have to broaden terms to capture equity compensation</li><li>✦ Equity clawbacks will be challenging to implement to re-capture gains for shares sold/ exercised during 3-year period<ul style="list-style-type: none"><li>– <b>Methodologies will need to be developed if gains on equity are included in the clawback; the issue of taxes paid by the executive will need to be resolved</b></li></ul></li></ul>  |
| Enhanced Disclosure | <ul style="list-style-type: none"><li>✦ Companies are expected to increase pay-for-performance discussion and potentially discuss performance versus peers</li><li>✦ Examination of pay relationships between the CEO and staff, as well as employee<ul style="list-style-type: none"><li>– <b>Issue is likely to be a hot topic among media/market commentators</b></li></ul></li><li>✦ Policies are expected to be established that forbid hedging as well as sale of company stock outside of a pre-programmed selling plan (10-b-5-1 program)</li><li>✦ Other areas expected to change include peer group, pay philosophy and metrics linked to pay-for-performance features</li><li>✦ Board structure and justification of roles (e.g., Lead Director, non-executive Chair)</li><li>✦ Expect to see more companies implement ownership requirements to improve governance and long-term focus for better alignment</li></ul> |



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## Implications

### Committee Independence

- ✦ Board member independence will become more critical
- ✦ Greater focus on committee process and use of executive sessions to address senior management compensation
  - Finding balance between oversight role and operational role will become more important (CEO is still accountable for the business operations)
  - Opportunity for HR to play a more strategic role with the Compensation Committee
- ✦ Increased disclosure on criteria used to select advisors and how the committee engages with management and the advisor in performed services
- ✦ Potential that large companies will have two advisors (e.g., Committee and management) to ensure separation of roles and independence



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Broker Discretionary Voting

## Implications

- ✦ Will impact director nominations making it more challenging where majority voting is in place
- ✦ Material executive compensation matters put to shareholder vote could face increased pressure to gain approval



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## What Should I do Following this Session?

Area of Focus	What You Need to Do:
CD&A	<ul style="list-style-type: none"><li>✦ Begin reviewing the CD&amp;A to determine that your plans are clear and free of boiler plate language; mock up an executive summary, look at performance against peers to support pay levels and pay decisions</li><li>✦ CD&amp;A will become a shareholder marketing communications not just a compliance document</li><li>✦ Consider involving a cross functional team in the process (e.g., finance, legal, HR and <i>Marketing Communications</i>)</li></ul>
Policy Review	<ul style="list-style-type: none"><li>✦ Examine change-on-control structure and consideration and see if it is still relevant</li><li>✦ Review involuntary termination practices versus policy to see if changes are required; consider elimination of performance-based plan features</li><li>✦ Develop a philosophy on clawbacks and gain input from the Compensation Committee (e.g., positions included, calculation of compensation to be recovered)</li><li>✦ Ownership requirements should be examined for compliance and/or policies considered (best practice considerations)</li><li>✦ Begin to review insider trading policies and hedging and determine if you have any areas of risk/ concern (e.g., 10-b-5-1)</li></ul>



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Area of Focus	What You Need to Do:
Compensation Design Review	<ul style="list-style-type: none"><li>✦ Examine the pay-for-performance features of your plans to market</li><li>✦ Look at pay-for-performance compared to your disclosed peers (e.g., 1, 3 and 5 years) for alignment</li><li>✦ Conduct an analysis of pay ratios (e.g., CEO to exec team, CEO to entry professional, support, domestically and globally) - understand how you compare to market</li><li>✦ Conduct analysis of "take away pay" under change-in-control for reasonableness</li></ul>
Other Areas	<ul style="list-style-type: none"><li>✦ Examine your Compensation Committee process, charter, schedule of activities and the role of outside advisors to be aligned with best practices</li><li>✦ Review shareholder base and profile to determine voting preferences, hot issues and potential areas of concern in your executive and equity compensation programs</li></ul>



# Questions? Thank You!

**Linda E. Amuso**, [lamuso@radford.com](mailto:lamuso@radford.com)  
+1 (415) 486-7255

**Christine McCarthy**, [cmccarthy@orrick.com](mailto:cmccarthy@orrick.com)  
+1 (650) 614-7634