The Dodd-Frank Act: Immediate and Longer-Term Impacts on Executive Compensation

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was enacted on July 21, 2010.[1] While the Dodd-Frank Act's primary purpose is to broadly reform the regulation of the financial services industry, within the massive text of the Dodd-Frank Act lurk new requirements that will impact executive compensation and corporate governance practices at most public companies, not just banks. This column explores these executive compensation and governance provisions, with a particular focus on the Dodd-Frank Act's new "proxy access" and "Say-on-Pay" rules.

The Dodd-Frank Act continues a string of statutory and regulatory developments over the last decade in response to turbulent economic markets that, in general, have sought to impose greater accountability on directors and managers through empowering shareholders.[2] Some of these developments include the NYSE and NASDAQ listing rules that require shareholder approval of almost all equity compensation plans and the evolution of the Securities and Exchange Commission (SEC) rules regarding the Management Discussion and Analysis included in the 10-K and the Compensation Discussion and Analysis (and related executive compensation disclosures) included in the annual proxy statement. Together, these stock exchange listing requirements and federal securities law reporting and disclosure requirements have created a form of federal corporate law that can significantly impact the internal organization and governance practices of public companies.

Table 1 highlights the key executive compensation and corporate governance provisions of the Dodd-Frank Act. As Table 1 indicates, many of the provisions will not become effective until the SEC or applicable securities exchanges issue final rules, and for most of the requirements final rules are not expected until after the second quarter of 2011. However, the "Say-on-Pay" provisions of the Dodd-Frank Act apply for any annual shareholder meetings occurring on or after

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Table 1. Dodd-Frank Act Overview of Key Executive Compensation and Governance Provisions

Provision	Act §	Brief Description	Effective Date and Rule Making Schedule
Say-on-Pay	951(a)	Non-binding shareholder vote on executive compensation as disclosed in the annual proxy statement	• Effective for annual shareholder meetings on or after 1/21/2011 • Proposed SEC rules published 10/18/2010; to be finalized by Q1 2011
Say-on-Frequency	951(a)	Non-binding shareholder vote on the frequency for the Say-on-Pay vote; choices are one, two or three year cycles; must provide Say-on-Frequency vote at least once every six years	• Same as for Say-on-Pay
Say-on-Golden Parachutes	951(b)	Non-binding shareholder vote on compensation to target company executives in certain M&A transactions	• Does not apply until SEC rules are finalized • Proposed SEC rules published 10/18/2010; to be finalized by Q1 2011
Compensation Committee Independence	952(a)	Heightened standards for "independence" of compensation committee members	• Not effective until rules finalized • Proposed rules to be published Nov.–Dec. 2010; to be finalized by July 2011
Compensation Consultant and Adviser Independence	952(b)	Mandates factors to be considered regarding independence of compensation consultants and other advisers to the compensation committee; does not mandate use of independent advisers	• Not effective until rules finalized • Proposed rules to be published Nov.–Dec. 2010; to be finalized by July 2011
Executive Compensation Disclosures	953	Requires "clear disclosures" in annual proxy statement of linkage between pay and performance; also requires disclosure of ratio of CEO pay to median employee pay	• Not effective until rules finalized • Proposed rules to be published April–July 2011; to be finalized after July 2011
Compensation Recovery (Clawbacks)	954	Requires policy on recovery of certain incentive awards to current and former executive officers that were based on financial information later restated	• Not effective until rules finalized • Proposed rules to be published April–July 2011; to be finalized after July 2011
Hedging Policies	955	Requires disclosure as to whether directors or employees of the company are permitted to hedge against stock price drops with respect to equity compensation awards	• Not effective until rules finalized • Proposed rules to be published April–July 2011; to be finalized after July 2011

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Provision	Act §	Brief Description	Effective Date and Rule Making Schedule
Excessive Compensation at Covered Financial Institutions	956	Prohibits "excessive compensation" or other incentive arrangements that could encourage "inappropriate risks" at certain "covered financial institutions"	• Not effective until rules finalized • Proposed rules to be published Nov.–Dec. 2010; to be finalized by July 2011
Broker Non-Votes	957	Prohibits discretionary voting by brokers on shares they do not beneficially own on (i) election of directors, (ii) executive compensation, and (iii) any other "significant matter" as determined by the SEC	• NYSE listing rules adopted in Sept. 2010, including clarification that this applies to shareholder votes under § 51 • Proposed rules to be published in April–July 2011 on "other significant matters"
Proxy Access	971	Authorizes (but does not require) the SEC to adopt rules allowing shareholders to nominate candidates for directors, using the company's proxy statement	• SEC adopted rules on 8/25/2010, but stayed the rules pending resolution of related litigation
CEO/Chairman Leadership Structures	972	Annual proxy statement disclosures regarding choice of leadership structure (*e.g.*, single CEO/Chairman vs. separate people in those roles)	• SEC required to issue rules by 1/21/2011

January 21, 2011 (the sixth month after enactment), meaning that these requirements will apply to the Spring 2011 proxy season.

Proxy Access

One of the most controversial governance provisions in the Dodd-Frank Act that best illustrates the focus on shareholder empowerment and the progress towards a federal corporate law is the provision regarding proxy access. Section 971 of the Dodd-Frank Act authorizes (but does not require) the SEC to adopt rules allowing shareholders to nominate candidates for directors, using the company's proxy statement. There were substantial debates in Congress over whether the Dodd-Frank Act should include requirements on the level or duration of shareholder ownership. However, due to powerful opposition from shareholder activist groups, these eligibility requirements, if any, were left up to the discretion of the SEC.

On August 25, 2010, the SEC adopted (in a 3–2 vote) rules intended to implement proxy access, in general allowing shareholders with at least a 3 percent ownership level held for at least three years to nominate a specified number of directors (in general, not to exceed

25 percent of the total board) through the company's annual proxy statement.[3] On October 4, 2010, in response to a lawsuit filed by the US Chamber of Commerce and Business Roundtable, the SEC issued an order staying the implementation of the new rules until the litigation can be resolved.[4] As a result, it is unlikely that proxy access rules will be effective for the Spring 2011 proxy season.

Proxy access has been a controversial subject for a number of years. The SEC has expressed a view that proxy access could make boards more responsive and accountable to shareholder interests. Others have suggested that the SEC lacks authority to adopt proxy access rules, which arguably infringe on internal corporate affairs that are ordinarily the province of state corporate law. Assuming the SEC proposed rules move forward at some point after the current litigation is resolved, it remains to be seen how state lawmakers may react.

The Say-on-Pay Rules: Three New Voting Requirements

The Dodd-Frank Act established three new non-binding shareholder votes. There is a degree of interconnectedness among all three:

1. Say-on-Pay. This is a shareholder vote on the compensation of the company's named executive officers as disclosed in the executive compensation sections of the annual proxy statement.

2. Say-on-Frequency. The Dodd-Frank Act requires that the Say-on-Pay vote be provided to shareholders on a cycle of every one, two, or three years. With the first Say-on-Pay vote, shareholders must be provided with an opportunity to vote on this one-, two-, or three-year frequency. This Say-on-Frequency vote must thereafter be provided to shareholders at least once every six years.

3. Say-on-Golden Parachutes. The Dodd-Frank Act provides shareholders with a separate vote over compensation paid to named executive officers in connection with shareholder approval of certain mergers, acquisitions or dispositions.

Each of these three votes is non-binding on the company. So what is the significance of the votes? The expectation is that companies will want to avoid negative shareholder votes. Even significant, but less than 50 percent, negative votes could signal meaningful shareholder discontent. Most advocates believe Say-on-Pay will lead companies to communicate more proactively with key shareholders to avoid an embarrassing outcome in the first place. Also, companies that receive an unfavorable vote and take no action will more likely face greater shareholder activism, such as vote "no" campaigns for directors or, once proxy access becomes effective, shareholder nominations of directors.

The Dodd-Frank Act also makes clear that these shareholder votes do not change or add fiduciary duties for the board and do not limit the ability of shareholders to submit proposals on executive compensation matters. Although the Say-on-Pay and Say-on-Frequency votes apply to annual shareholder meetings occurring on or after January 21, 2011,[5] the Say-on-Golden Parachute vote will not become effective until SEC rules specifying the required disclosures have become effective. The SEC proposed rules on October 18, 2010,[6] and anticipates issuing final rules sometime in the first quarter of 2011.[7]

Say-on-Pay votes are not a completely new development in the United States. Over the last several years, a number of companies voluntarily instituted Say-on-Pay votes. Also, banks receiving financial assistance under the Troubled Asset Relief Program were required to provide a Say-on-Pay vote. During 2010, over three hundred US companies included Say-on-Pay votes in their proxy statements. Only three failed to receive majority votes in favor of their resolutions.[8] Under the Dodd-Frank Act and NYSE rulemaking, however, broker non-votes—that is, discretionary votes by brokers on shares they do not beneficially own—will not be counted for purposes of these Say-on-Pay votes.[9] The exclusion of broker non-votes will make obtaining majority votes for Say-on-Pay resolutions more challenging going forward. The following provides additional details about each of the three votes.

The Say-on-Pay Vote

The Say-on-Pay vote provides shareholders with a non-binding vote on the compensation of the company's executives, as disclosed in the proxy statement. The executive compensation disclosures covered by the vote include the Compensation Discussion and Analysis, Summary Compensation Table, other compensation tables, and related narrative discussions. The vote does not cover director compensation.

The Dodd-Frank Act does not specify the form of the resolution, nor does it mandate positioning or supporting statements. A minimalist form of the resolution might appear something like this:

> RESOLVED, that the shareholders approve the compensation of the Company's named executive officers, as disclosed under the Compensation Discussion and Analysis, compensation tables and related materials as set forth in this proxy statement under the caption "Executive Compensation" beginning at pg. ____.

Some companies may want to consider other formulations of the resolution, perhaps even separating it into separate resolutions, in order to obtain more actionable information from the vote or to better focus shareholder communications. Any formulation must ultimately cover all of the executive compensation disclosures in the proxy statement. For example, a resolution simply approving the company's executive compensation policies and practices would not be sufficient under the Dodd-Frank Act. Also, companies will need to consider whether to develop detailed supporting statements to accompany the resolution or instead to rely principally on the quality of the disclosures. It may make the most sense to place the resolution immediately after the executive compensation disclosures. In any event, a variety of practices will likely unfold in the Spring 2011 proxy season as both companies and shareholders accustom themselves to the new rules.

If a company receives a negative vote, the proposed SEC rules would require the company to disclose in its next Compensation Discussion and Analysis whether, and if so how, the company has taken into account the outcome of the vote. For example, has the company made changes to its executive compensation programs in response to the vote, and if so, what changes were made?

The Say-on-Frequency Vote

The first Say-on-Frequency vote must accompany the first Say-on-Pay vote, and thereafter must re-occur at least once every six years. For many companies, this will mean the first Say-on-Frequency vote will occur in the Spring 2011 proxy statement.

Under the SEC proposed rules, shareholders must be given four alternatives:

1. A Say-on-Pay vote every year;
2. A Say-on-Pay vote once every two years;
3. A Say-on-Pay vote once every three years; or
4. Abstain.

For the Spring 2011 proxy season, the SEC has recognized that some companies may have difficultly providing four choices on a proxy card, because most votes usually only require three choices—that is, yes, no, or abstain. Accordingly, the proposed rules contemplate three choices for the first year of the vote as a transitional matter—that is, a one-year, two-year, or three-year frequency vote, with a failure to vote deemed to be an abstention. Management may include a recommendation on the vote, but all of the choices must be presented on the proxy card.

It is clear that many institutional shareholders and their advisers will advocate for an annual cycle. For example, Institutional Shareholder Services (ISS) has stated in its Policy Updates for 2011 that it will recommend annual Say-on-Pay votes.[10] It is not clear which alternative will become the predominant management recommendation or adopted practice.

Under the SEC proposed rules, whichever alternative receives the plurality of votes, if the company adopts that alternative then the company may exclude future shareholder proposals asking for a different frequency.

The Say-on-Golden Parachutes Vote

The Say-on-Golden Parachutes vote is triggered when a company (the "target") seeks shareholder approval of a proposed acquisition, merger, consolidation or proposed sale or disposition of all or substantially all of its assets. The Dodd-Frank Act and the SEC proposed rules require disclosure "in a clear and simple form" of all compensation for the target's and, potentially, the buyer's named executive officers that is based on or otherwise relates to the transaction. The Say-on-Golden Parachutes disclosures would be in addition to any other disclosures required regarding potential interests that the target's directors and executive officers have in the transaction.

To facilitate disclosure in a "clear and simple form," the SEC proposed rules include the following figure:

Table 2. Golden Parachute Compensation

Name	Cash ($)	Equity ($)	Pension/ NQDC ($)	Perquisites/ Benefits ($)	Tax Reimbursement ($)	Other ($)	Total ($)
PEO							
PFO							
A							
B							
C							

In addition to the quantitative disclosures provided by Table 2, the target would need to describe the circumstances that trigger payments and any conditions on payments (such as covenants or non-competes). In addition to target obligations, the disclosures must include compensation under any arrangements between the buyer and the target company's named executive officers (other than bona fide post-transaction employment arrangements), although under the proposed SEC rules the Say-on-Golden Parachutes vote for the target company would not cover those arrangements between the buyer and the target's named executive officers. If the buyer's named executive officers have golden parachute arrangements triggered by the transaction, disclosure and a vote will be required of those arrangements. The Say-on-Golden Parachutes vote will also apply to the buyer's shareholders if the buyer is required to solicit shareholder approval of the transaction.

The Dodd-Frank Act generally requires that the Say-on-Golden Parachutes vote be a separate vote from the approval of the transaction. The Dodd-Frank Act, however, contemplates that such arrangements could potentially be disclosed and approved as part of the Say-on-Pay vote. If so, an additional Say-on-Golden Parachutes vote would not be required as part of the transaction for those arrangements.

The SEC proposed rules clarify that to take advantage of this exception, the annual proxy statement must include the Say-on-Golden Parachutes disclosures, including Table 2 shown above. Annual proxy statements already must include disclosure about potential payments to named executive officers upon termination of employment or change in control, so the addition of the new Say-on-Golden Parachutes table in the annual proxy statement, in order to take advantage of this exception, may be an attractive alternative to some companies, particularly if a transaction may be pending in the near future. A Say-on-Golden Parachutes vote would still be required in the transaction, however, for any new or modified golden parachute arrangements that have not been previously approved in a Say-on-Pay vote. In such a case, the target would have two Say-on-Golden Parachutes tables in its transaction proxy statement, one addressing arrangements covered by a prior Say-on-Pay vote and the other covering any new or modified arrangements.

The Role of ISS and Other Proxy Advisers in Say-on-Pay Votes

As federal law has tended towards empowering shareholders through enhanced disclosures and voting rights, many shareholders have sought outside advisers to assist in analyzing the mass of corporate disclosures in order to make informed voting decisions. This trend has helped lead to the growing influence of proxy advisory firms. The Dodd-Frank Act's Say-on-Pay rules will likely increase the influence of proxy advisory firms. As the New York Stock Exchange Commission on Corporate Governance recently observed, the growing role of proxy advisory firms, and the relative lack of transparency on many of their voting guidelines, suggests that these firms should become subject to greater regulatory oversight.[11] The following summarizes the current Say-on-Pay perspectives of several key players.

ISS

ISS is widely recognized as the most influential proxy advisory firm. For the last several years, ISS's US voting policies have included information about how ISS will view Say-on-Pay votes. In general, ISS will apply a case-by-case analysis. In its 2011 Policy Updates, however, ISS identifies several key "problematic pay practices" that will likely result in a recommendation by ISS against approving the company's executive compensation practices.[12] The three most egregious pay practices under the ISS Policy are:

- Repricing underwater stock options without shareholder approval;
- Change in control severance payments not triggered by an involuntary termination of employment (such as "single trigger" or "modified single trigger" payments); and
- Change in control excise tax gross-ups.

Other significant problematic pay practices under the ISS policy include:

- Multi-year compensation guarantees;
- Excessive perks;
- Tax gross-ups on perks;
- Change in control severance payments exceeding three times base salary and target bonus;
- Dividend payments on unvested restricted stock; and
- Executives engaged in hedging against company stock.

In prior years, companies cited with problematic pay practices could avoid negative recommendations from ISS by publicly committing to changing those practices. In its 2011 Policy Updates, ISS states that permitting these public commitments was only a transitional approach by ISS, and going forward public commitments to change practices will no longer be considered in ISS's analysis.

Glass Lewis

Glass Lewis & Co. is another widely cited proxy advisory firm. In many ways, their voting policies are less publicly transparent than those of ISS. In their 2008 policy on "Compensation Committee Performance," they indicate that their primary focus is analyzing the linkage between pay and performance.[13] As part of this analysis, they take into account the following:

- The extent to which the company uses performance goals;
- The quality of the company's disclosure about its performance goals;

- The use of peer groups by the company to compare both pay and performance; and
- The extent to which management retains discretion to deviate from the performance goals.

CII

The Council for Institutional Investors (CII) focuses on representing the interests of public, union, and corporate pension funds, and currently has more than 140 members with combined assets that exceed $3 trillion.[14] In March 2010, the CII published its own guidance on Say-on-Pay votes, citing 10 "red flag" practices to watch out for.[15] Similar to ISS, the CII list focuses on poor pay practices that CII believes potentially signal "excessive risk-taking and get-rich-quick mentalities," including the following:

- A lack of stock ownership by executives or of appropriate stock ownership policies by the company;
- An absence of compensation recovery (clawback) policies;
- Poor practices in incentive design, such as using the same performance metrics for both annual and long-term incentives;
- Excessive perks;
- Poor internal pay equity (*i.e.*, CEO pay significantly higher than the next tier of management);
- Unclear disclosure of performance goals or paying a bonus even if performance goals are not met;
- Excessive post-employment compensation packages, including severance arrangements that potentially "pay for failure," excessive change in control compensation, and SERPs;
- Poor disclosures in the Compensation Discussion and Analysis; and
- Concerns about the independence of compensation consultants.

What to Do Now

Given the immediacy of the Say-on-Pay and Say-on-Frequency votes, there are a number of steps most public companies should be taking to meet these new challenges:

- Continue to monitor SEC and securities exchange rule-making initiatives under the Dodd-Frank Act, including final SEC Say-on-Pay rules;
- Decide on the form and placement of the Say-on-Pay vote and whether any additional supporting statements should be included;
- Identify key shareholders and consider whether to discuss with them their perspectives on the company's executive compensation programs. This could help focus the development of the proxy statement disclosures;
- Continue to strive towards clear, concise, and meaningful executive compensation disclosures, and in particular focus on clearly describing how the company links executive pay to performance. For this purpose, illustrative charts or graphs may be helpful;
- Decide which frequency for the Say-on-Pay vote management will recommend in connection with the Say-on-Frequency vote, and consider the supporting statement for this recommendation;
- Consider whether to include the Say-on-Golden Parachutes disclosures in the annual proxy statement; and
- Continue to track voting policy developments at key proxy advisory firms and other influential groups. In particular, consider whether any of the company's practices may be considered poor pay practices under those policies, and if so, how concerns about those practices are best addressed.

Notes

1. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. Law 111-203, enacted July 21, 2010).

2. For an excellent discussion on how current thinking on corporate governance best practices has evolved over the last decade, *see* Report of the New York Stock Exchange Commission on Corporate Governance (September 23, 2010) at *http://www.nyse.com/pdfs/CCGReport.pdf*.

3. *See* "Facilitating Shareholder Director Nominations" (August 25, 2010), Release Nos. 33-9136 and 34-62764, at *http://www.sec.gov/rules/final/2010/33-9136.pdf*.

4. *See* "Order Granting Stay" (October 4, 2010), Release Nos. 33-9149 and 34-63031, at *http://www.sec.gov/rules/other/2010/33-9149.pdf*.

5. Banks that received financial assistance under the Troubled Asset Relief Program (TARP) are separately subject to a Say-on-Pay requirement under that program. Under

SEC proposed rules (see Note 6 below), the Say-on-Pay and Say-on-Frequency votes under the Act will not apply until after the bank ceases to be covered by the TARP requirement.

6. *See* "Shareholder Approval of Executive Compensation and Golden Parachute Compensation," Release Nos. 33-9153 and 34-63124, at *http://www.sec.gov/rules/proposed/2010/33-9153.pdf*.

7. *See* "Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Upcoming Activity," at *http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml*.

8. Those three companies were KeyCorp, Motorola, and Occidental Petroleum.

9. *See* SEC Release No. 34-62874 (September 9, 2010) at *http://www.sec.gov/rules/sro/nyse/2010/34-62874.pdf*.

10. *See* ISS US Corporate Governance Policy, 2011 Updates (November 19, 2010) at *http://www.issgovernance.com/policy/2011/policy_information*.

11. *See* Principle 8 at page 6 of the Report of the New York Stock Exchange Commission on Corporate Governance, Note 2 above.

12. *See* "Corporate Governance Issue: Problematic Pay Practices" in the ISS Corporate Governance Policy, 2011 Updates cited in Note 10 above.

13. *See* Glass Lewis & Co., "Compensation Committee Performance" (April 2008), at *http://www.compensationstandards.com/Member/Memos/Firms/Glass/04_08_advisory.pdf*.

14. *See* CII Web site at *http://www.cii.org/about/history*.

15. *See* Council for Institutional Shareholders, "Top 10 Red Flags to Watch for When Casting an Advisory Vote on Executive Pay" (March 2010), at *http://www.compensationstandards.com/Member/Memos/Firms/CII/04_10_checklist.pdf*.